

1-1988

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Jeffrey M. Judd

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### Recommended Citation

Jeffrey M. Judd, *The Implied Covenant of Good Faith and Fair Dealing: Examining Employees' Good Faith Duties*, 39 HASTINGS L.J. 483 (1988).

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# The Implied Covenant of Good Faith and Fair Dealing: Examining Employees' Good Faith Duties

by  
JEFFREY M. JUDD\*

The implied covenant of good faith and fair dealing is widely recognized as fundamental to the law of contracts.<sup>1</sup> Courts consistently construe this covenant as binding on all parties to a contract.<sup>2</sup> In a number of cases dealing primarily with insurance contracts, several jurisdictions use the implied covenant to permit relief in tort as well as in contract for breach of the implied covenant of good faith and fair dealing.

Courts have reasoned that relationships exhibiting certain "special" qualities require the protections provided by tort remedies, which are otherwise unavailable in contract actions.<sup>3</sup> In addition to recognizing a tort theory for breach of the implied covenant of good faith and fair dealing in insurance contracts, courts have extended this theory to surety contracts,<sup>4</sup> loan agreements,<sup>5</sup> commercial leases,<sup>6</sup> attorneys' fees agree-

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\* Member, Third Year Class.

1. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979); U.C.C. § 1-203 (1978); A. CORBIN, CORBIN ON CONTRACTS § 654D, at 795 (Supp. 1980). The development of the implied covenant can be traced back to *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933); *Brassil v. Maryland Casualty*, 210 N.Y. 235, 242, 104 N.E. 622, 624 (1914); *Brown v. Superior Court*, 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949); *Nelson v. Abraham*, 29 Cal. 2d 745, 750-51, 177 P.2d 931, 934 (1947); and *Universal Sales Corp. v. California Press Mfg.*, 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942).

2. *Commercial Union Assurance Cos. v. Safeway Stores*, 26 Cal. 3d 912, 918, 610 P.2d 1038, 1041, 164 Cal. Rptr. 709, 712 (1980); *Liberty Mut. Ins. Co. v. Altfillisch Constr. Co.*, 70 Cal. App. 3d 789, 797, 139 Cal. Rptr. 91, 95 (1977).

3. See *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 768-69, 777-79, 686 P.2d 1158, 1166, 1173, 206 Cal. Rptr. 354, 362, 368-69 (1984); *Wallis v. Superior Court (Kroehler Mfg. Co.)*, 160 Cal. App. 3d 1109, 1118-19, 207 Cal. Rptr. 123, 128-29 (1984).

4. *Johnson v. Safeco Ins. of Am.*, 265 Ark. 9, 576 S.W.2d 220 (1979) (while holding surety not in breach of implied covenant, the court recognized in dicta the appropriateness of bad faith actions in the surety context, noting that a surety might have more defenses available than an insurer in such an action); *Fisher v. Fidelity & Deposit Co.*, 125 Ill. App. 3d 632, 466 N.E.2d 332 (1984) (treating contracts of compensated suretyship as contracts of insurance in bad faith actions); *New Amsterdam Casualty v. Lundquist*, 293 Minn. 274, 198 N.W.2d 543 (1972) (applying good faith insurance law to a surety, the court required an indemnitee to communicate settlement offers to its indemnitors, or be limited in its recovery from indemnitors to the settlement amount). Other tortious breach of the implied covenant cases involving sureties include *French Am. Banking Corp. v. Flota Mercante Grancolombiana*, 609 F. Supp.

ments,<sup>7</sup> franchise agreements,<sup>8</sup> and various other non-insurance contracts.<sup>9</sup> Similarly, a number of courts allow a former employee to state a tort cause of action against his former employer for breach of the implied covenant of good faith and fair dealing in connection with the employee's termination.<sup>10</sup>

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1352 (S.D.N.Y. 1985); *Continental Realty Corp. v. Andrew J. Crevolin Co.*, 380 F. Supp. 246 (S.D. W.Va. 1974); and *Suver v. Personal Serv. Ins.*, 11 Ohio St. 3d 6, 462 N.E.2d 415 (1984).

5. *Tribby v. Northwestern Bank of Great Falls*, 704 P.2d 409 (Mont. 1985) (evidence supporting finding of reckless disregard of plaintiff's rights as a customer justified jury instruction to consider tort damages for breach of the implied covenant); *First Nat'l Bank v. Twombly*, 689 P.2d 1226 (Mont. 1984) (bank's acceleration of loan and unilateral offset against borrower's checking account was a breach of statutory duty to exercise good faith; tort damages, including punitive damages, held justified and proper); *cf. Wagner v. Benson*, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980) (although finding bank innocent of tortious conduct, court assumed that a bad faith cause of action may arise from a borrower-lender relationship); *Sawyer v. Bank of Am.*, 83 Cal. App. 3d 135, 145 Cal. Rptr. 623 (1978) (tortious breach of the implied covenant requires bad faith action, extraneous to the contract, with the motive and intent to frustrate the obligee's enjoyment of contract rights).

6. *Nicholson v. United Pac. Ins.*, 710 P.2d 1342 (Mont. 1985) (breach of the implied covenant occurs when one party acts arbitrarily, capriciously, or unreasonably, and contrary to the reasonable expectations of the other party).

7. *Morse v. Espeland*, 696 P.2d 428 (Mont. 1985) (analogizing to its decisions regarding bad faith in the employment context, the court held an attorney owed his client a duty of good faith and fair dealing when negotiating a fee and when ultimately charging and collecting the fee).

8. *Dunfee v. Baskin-Robbins, Inc.*, 720 P.2d 1148 (Mont. 1986) (franchisor's refusal to allow its franchisee to relocate its ice cream parlor was a breach of the implied covenant because it was based on a failure to properly review franchisee's request).

9. *Reid v. Key Bank*, 821 F.2d 9 (1st Cir. 1987) (all contracts, including those between bank and commercial borrowers, require good faith performance); *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (dicta) (the tort of bad faith breach available in noninsurance contract cases); *Mitchell v. Bailey & Selover Inc.*, 96 Nev. 147, 605 P.2d 1138 (1980) (U.C.C. obligation of good faith and fair dealing applied to enforce warehouseman's lien); *Hall v. Farmer's Ins. Exch.*, 713 P.2d 1027 (Okla. 1985) (principal liable in tort for bad faith termination of agency); *EKE Builders v. Quail Bluff Assocs.*, 714 P.2d 604 (Okla. Ct. App. 1985) (implied covenant to act in good faith and deal fairly inheres in all contracts).

10. *Petersen v. First Fed. Sav. & Loan Ass'n*, 617 F. Supp. 1039 (D.V.I. 1985) (following *Robinson v. Hess Oil Virgin Islands Corp.*, 19 V.I. 106 1982), recognizing good faith limitation to the "at-will" rule); *Savage v. Holiday Inn Corp.*, 603 F. Supp. 311 (D. Nev. 1985) (Nevada recognizes cause of action for breach of the implied covenant); *Craft v. Metromedia*, 572 F. Supp. 868 (W.D. Mo. 1983), *aff'd in part and rev'd in part*, 766 F.2d 1205 (8th Cir. 1985), *cert. denied*, 106 S. Ct. 1285 (1986); *Carter v. Catamore Co.*, 571 F. Supp. 94 (N.D. Ill. 1983) (relying on Rhode Island precedent in the insurance context, the court held that breach of the implied covenant sounds in tort as well as contract, and punitive damages may be awarded where the employer demonstrates malice, or willful and wanton conduct); *Robinson*, 19 V.I. 106 (recognizing the good faith limitation on the "at-will" employment rule); *Wagenseller v. Scottsdale Memorial Hosp.*, 147 Ariz. 370, 710 P.2d 1025 (1985) (implied covenant protects employee from discharge based on the employer's desire to avoid paying benefits already earned); *Cook v. Alexander & Alexander*, 40 Conn. Sup. 246, 488 A.2d 1295 (1985) (approving application of the good faith theory in employment contracts "in the restricted manner illustrated by the Massachusetts cases"); *Foley v. Interactive Data Corp.*, 174 Cal. App. 3d

This Note argues that, consistent with this trend, under appropriate circumstances a court might find that an employee who abuses a special position of trust and confidence is liable to his employer for tortious breach of the covenant of good faith and fair dealing implied in his employment contract. Although no court has yet advanced this application of the implied covenant,<sup>11</sup> no current legal authority clearly prevents an employer from asserting such a claim against an employee.<sup>12</sup>

At least three factors suggest that an employer's cause of action for tortious breach of the implied covenant may sometimes be appropriate. First, courts that recognize a tort theory for breach of the implied covenant are primarily concerned with the abuse of some "special relation-

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282, 219 Cal. Rptr. 866 (1985) (seven years insufficient to justify implied covenant claims), *review granted*, 184 Cal. App. 3d 241, 222 Cal. Rptr. 740, 712 P.2d 891 (1986); *Khanna v. Microdata Corp.*, 170 Cal. App. 3d 250, 215 Cal. Rptr. 860 (1985) (implied covenant breach established whenever employer engages in bad faith action with intent to interfere with employee's contract rights); *Rulon-Miller v. IBM*, 162 Cal. App. 3d 241, 208 Cal. Rptr. 524 (1984) (implied covenant requires an employer to treat like cases alike when applying corporate policy); *Newfield v. Ins. Co. of the West*, 156 Cal. App. 3d 440, 203 Cal. Rptr. 9 (1984) (implied covenant claim requires combination of elements, especially longevity of service); *Shapiro v. Wells Fargo Realty Advisors*, 152 Cal. App. 3d 467, 199 Cal. Rptr. 613 (1984) (implied covenant requires more than three and a half years employment, employer's failure to follow its express policy, or bad faith action extraneous to the contract); *Crozier v. United Parcel Serv., Inc.*, 150 Cal. App. 3d 1132, 198 Cal. Rptr. 361 (1983) (employee must prove facts establishing breach of implied covenant); *Cleary v. American Airlines*, 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980) (termination of employee without legal cause after 18 years of service); *Crenshaw v. Bozeman Deaconess Hosp.*, 693 P.2d 487 (Mont. 1984) (following *Gates v. Life of Montana*, 196 Mont. 178, 668 P.2d 213 (1983)); *Dare v. Montana Petroleum Mktg.*, 687 P.2d 1015 (Mont. 1984) (same); *Gates v. Life of Montana*, 196 Mont. 178, 668 P.2d 213 (1983) ("breach of a duty to deal fairly and in good faith in the employment relationship is a tort for which punitive damages can be recovered" for sufficiently culpable conduct).

Other states have expressly refused to impose a good faith standard in employment contracts. *See, e.g., Muller v. Stromberg Carlson Corp.*, 427 So. 2d 266, 270 (Fla. Dist. Ct. App. 1983); *Parner v. Americana Hotels, Inc.*, 65 Haw. 370, 377, 652 P.2d 625, 629 (1982); *Morriss v. Coleman Co., Inc.*, 241 Kan. 501, 512, 738 P.2d 841, 851 (1987); *Bottijliso v. Hutchison Fruit*, 96 N.M. 789, 794-95, 635 P.2d 992, 997-98 (N.M. Ct. App. 1981); *Murphy v. American Home Prods. Corp.*, 58 N.Y.2d 293, 304-05, 448 N.E.2d 86, 91, 461 N.Y.S.2d 232, 237 (1983); *Brockmeyer v. Dun & Bradstreet*, 113 Wis. 2d 561, 572-73, 335 N.W.2d 834, 838 (1983).

11. In *Hudson v. Moore Business Forms*, 609 F. Supp. 467 (N.D. Cal. 1985), *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987), the first case to explicitly address the issue, a federal district court applying California law prevented the defendant in a wrongful discharge case from counterclaiming for breach of the implied covenant of good faith and fair dealing against its former employee. Finding the claim "spurious," *id.* at 481, the court reasoned that "only 'the party in the stronger position,' *i.e.*, the employer, can be held liable in tort for breach of the covenant of good faith and fair dealing implied in an employment contract." *Id.* at 479. A literal application of *Hudson's* language might prevent a court from ever finding an employee liable for tortious breach of the implied covenant.

12. Besides *Hudson*, no court has ruled on such a claim. Therefore, in most jurisdictions, the question of a claim for employee's breach of the implied covenant of good faith and fair dealing will be one of first impression. *Id.* at 478.

ship.”<sup>13</sup> Therefore, when the employee abuses some “special relationship,” such as a position of extraordinary trust and confidence, the employer should be able to state a cause of action against the employee for breach of the implied covenant.<sup>14</sup>

Second, the employee has always owed specific common-law duties to his employer in tort, implied in law by virtue of the employment relationship, or, more recently, by the employment contract. It is a small analytical leap to see these employee duties as specific examples of the broader duties contained within the implied covenant of good faith and fair dealing.

Third, in the context of insurance contract litigation, from which tortious breach of the implied covenant actions were derived, the courts seem willing to allow an insurer to assert a claim of breach of the implied covenant against its insured.<sup>15</sup> Since cases extending liability for breach of the implied covenant to the employer have likened the employer to the insurer,<sup>16</sup> the employer should similarly be allowed to assert implied covenant actions against its employees.

Part I of this Note briefly analyzes the evolution of a cause of action for tortious breach of the implied covenant of good faith and fair dealing, from its insurance case origins to its application in the wrongful termination context. The “special relationship” elements common to, and essential for, the assertion of tortious breach of the implied covenant are considered in the context of an employee’s potential breach of the implied covenant.

Part II analyzes the traditional common-law torts that recognize specific, affirmative duties owed by the employee to his employer and examines their common underlying “good faith” elements. The employee’s common-law duties illustrate that the level of trust given to an employee will often determine the standard of conduct to which the employee will be held in performing these duties. Finally, the Note reviews the common law of employee duties to show gaps in the protection cur-

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13. See *infra* notes 63-86 and accompanying text.

14. The tort remedy discussed herein would be extremely limited in application. Practically, the trust and confidentiality requirement limits the class of potential defendants to employees such as managers, creative talent, research and development personnel, and supervisors. This limitation is consistent with the line of cases distinguishing insurance and other contracts displaying “quasi-fiduciary” elements from ordinary commercial contracts. See *infra* notes 101-06, 186-98 and accompanying text.

Commentators and courts have expressed the justifiable concern that, if tortious breach cases are not limited, virtually any breach of contract will be subject to tort damages. See *infra* notes 212-17 and accompanying text. An action available to employers against employees without limitation would likely discourage employees from asserting their lawful rights. *Hudson*, 609 F. Supp. at 480.

15. See *infra* notes 147-64 and accompanying text.

16. See *infra* notes 63-66 and accompanying text.

rently available to an employer for damages caused by an employee's acts in breach of the implied covenant.

Using the insurance case analogy and the "special relationship" concept, part III constructs a theory for an employee's tortious breach of the implied covenant. The viability of this theory is then analyzed in light of *Hudson v. Moore Business Forms*, the only case that has addressed the issue of employee liability under the covenant. This analysis queries when, if ever, the employee should be liable in tort to his employer for breach of the implied covenant.

This Note concludes that, in theory, an employer should be able to state an independent claim or affirmative defense based on tortious breach of the employee's duty of good faith and fair dealing. This Note suggests that the limited application of such an action and the resulting chilling effect it would have on employees' assertions of their rights against employers confine the theory's usefulness and desirability to defensive applications.

## I. Origin of the Good Faith Tort Action

Traditionally, courts treated breach of the implied covenant of good faith and fair dealing<sup>17</sup> as a breach of contract, and limited damages recoveries to those normally awarded in contract actions.<sup>18</sup> In more recent

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17. The RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) comment *a* discusses the meaning of "good faith," by referring to U.C.C. § 1-201(19) (1979) ("honesty in fact in the conduct of transaction") and U.C.C. § 2-103(1)(b) (standard of merchants is "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade"). U.C.C. § 1-201(19) requires a subjective element ("honesty" being a state of mind) as the standard for all parties to sales of goods contracts, while § 2-103(1)(b) adds the objective standard of "reasonable commercial standards of fair dealing in the trade," imposed on merchants.

A number of commentators consider the meaning of "good faith" to be a function of the context within which it operates. See Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 668-72 (1963); Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 207-15 (1968). The RESTATEMENT (SECOND) OF CONTRACTS, § 205 (1979) apparently endorses this view. See *id.* comments *b-e*; *Egan v. Mutual of Omaha Ins.*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979) (concept stated in terms of the "nature and extent" of the duty of good faith and fair dealing as being "contingent upon the purpose of the particular contract"), *appeal dismissed, cert. denied*, 445 U.S. 912 (1980).

In non-U.C.C. cases, the duty of good faith and fair dealing is found in *Brown v. Superior Court*, 34 Cal. 2d 559, 212 P.2d 878 (1949): "In every contract there is an implied covenant of good faith and fair dealing that neither party will do anything which injures the right of the other to receive the benefits of the agreement." *Id.* at 564, 212 P.2d at 881 (citation omitted). For a comprehensive list of cases recognizing a general obligation of good faith performance in every contract at common law, see Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 (1980).

18. *Wagenseller v. Scottsdale Memorial Hosp.*, 147 Ariz. 370, 383, 710 P.2d 1025, 1038 (1985) (the duty not to act in bad faith or deal unfairly becomes a part of the contract, and, as with any other element of the contract, the remedy for its breach generally is on the contract

years, courts have allowed recovery in tort<sup>19</sup> in "special relationship" situations.<sup>20</sup> The basic rationale behind this development lies in the fundamental differences between tort and contract remedies and the public policy goals of each.

A principal distinction between tort and contract actions for breach of the implied covenant is the relief available to prevailing plaintiffs.<sup>21</sup> Generally speaking, the purposes of tort liability are to compensate for injuries and to deter wrongful conduct.<sup>22</sup> Punitive or exemplary damages are available to a plaintiff who can prove an element of outrage, such as malice, fraud, or willful and wanton behavior.<sup>23</sup> Tort law thus

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itself); *Nicholson v. United Pac. Ins.*, 710 P.2d 1342, 1348 (Mont. 1985) (distinguishing intentional contract breaches motivated by self-interest which justify contract damages from other egregious acts that give rise to tort damages); see *Summers*, *supra* note 17, at 216-20 (development of good faith causes of action); see also *Universal Sales Corp. v. California Press Mfg.*, 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942) (dispute over a contract for the purchase of machinery); *Fortune v. National Cash Register*, 373 Mass. 96, 97, 364 N.E. 2d 1251, 1253 (1977) (dispute over commissions earned from sales on behalf of employer); *Wilson v. Mechanical Orguinett*, 170 N.Y. 542, 545, 63 N.E. 550, 550 (1902) (dispute over royalties accruing from patent rights); *Genet v. President of Del. & H. Canal*, 136 N.Y. 593, 608, 32 N.E. 1078, 1081-82 (1893) (dispute over royalties accruing from a coal mine).

19. The first case recognizing a tort cause of action based on the implied covenant was *Hilker v. Western Auto. Ins. Co.*, 204 Wis. 1, 8-9, 231 N.W. 257, 258 (1930) (insurance), *holding clarified*, 235 N.W. 413 (1931). Before *Hilker*, the courts recognized tort actions against insurers to protect insureds from insurance adjustment abuses in third-party cases. See S. ASHLEY, *BAD FAITH ACTIONS* §§ 2:03-2:06 (1984). *Hilker* linked the implied covenant articulated in *Brassil v. Maryland Casualty*, 210 N.Y. 235, 104 N.E. 622 (1914) (an implied promise that neither party would do anything to deprive the other party of the benefits of the bargain), with the emerging tort cause of action for bad faith against insurers. See S. ASHLEY, *supra*, §§ 2:03-2:06

A series of California insurance cases extended the implied covenant tort action to first-party insurance cases. See *Egan v. Mutual of Omaha Ins.*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979), *appeal dismissed, cert. denied*, 445 U.S. 912 (1980); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); see also Kornblum, *Recent Cases Interpreting the Implied Covenant of Good Faith and Fair Dealing*, 30 DEF. L.J. 411, 431-32 (1980) (collecting cases); *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978); *Silberg v. California Life Ins.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *Gruenberg v. Aetna Ins.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *infra* notes 38-52 and accompanying text.

20. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 768, 769, 686 P.2d 1158, 1166, 1172, 206 Cal. Rptr. 354, 362, 367 (1984); see also *Aluevich v. Harrah's*, 99 Nev. 215, 216, 660 P.2d 986, 987 (1983) (referring to the "special element of reliance such as that found in partnership, insurance and franchise agreements"), *cert. denied*, 465 U.S. 1006 (1984)

21. See *Louderback & Jurika, Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187, 191 (1982); Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CALIF. L. REV. 1291, 1291-92 (1985).

22. W. KEETON, *PROSSER AND KEETON ON THE LAW OF TORTS* § 92, at 655 (5th ed. 1984); see *RESTATEMENT (SECOND) OF TORTS* § 901 (1977); see also W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 92, at 613 (4th ed. 1971) (tort remedies seek to deter injurers rather than merely set a price for violations).

23. W. KEETON, *supra* note 22, § 2, at 9-12.

promotes conduct that is socially reasonable and deters behavior that is unreasonable or socially harmful.<sup>24</sup>

Contract damages, on the other hand, traditionally do not distinguish between "willful" and other breaches.<sup>25</sup> In general, the law does not attempt to compel contract performance with the threat of contract damages.<sup>26</sup> Rather, the policy behind these damages encourages the breach of promises when economically efficient. When the breach of a promise creates value for the promisor in excess of the value expected by the performance of the promise, the promisor is free to breach and pay damages to the promisee, on the theory that society at large will benefit economically.<sup>27</sup> Because a breach of promise is not itself thought socially harmful, courts have traditionally limited contract damages to place the aggrieved party "in as good a[n economic] position as if the other party had fully performed."<sup>28</sup> Punitive damages are thus denied in breach of contract cases.<sup>29</sup>

While economically efficient breaches of contract benefit society,<sup>30</sup>

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24. *Id.* § 1, at 6.

25. *Nicholson v. United Pac. Ins.*, 710 P.2d 1342, 1348 (Mont. 1985) (intentional contract breaches motivated by self-interest justify contract damages only); see Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else.").

26. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 106 (3d ed. 1986) ("[I]t is not the policy of the law to compel adherence to contracts but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform.").

27. "Permitting parties to breach their contracts promotes an efficient economy, at least when the gains from the breach exceed the expected pecuniary injuries of the promisee." Diamond, *The Tort of Bad Faith Breach of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions*, 64 MARQ. L. REV. 425, 453-54 (1981). This theory of economic breach was acknowledged by the dissent in *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 778-79, 686 P.2d 1158, 1173, 206 Cal. Rptr. 354, 369 (Bird, C.J., dissenting).

28. U.C.C. § 1-106(1) (1978); see also RESTATEMENT (SECOND) OF CONTRACTS § 344 (1979). The *Hadley v. Baxendale* rule further limits special damages to those known to the breaching party at the time of contract formation. *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854); see also RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979) (damages limited to those foreseen by breaching party at contract formation).

29. E. FARNSWORTH, *CONTRACTS* § 12.8, at 842 (1982). This is generally true, regardless how malicious the breach. See Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 219 (1977); see also Comment, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case*, 71 IOWA L. REV. 893 (1986) (discussing limitations on punitive damage awards in contract actions).

30. By limiting contract damages, society benefits by the increased production of goods and services at lower overall cost, according to the theory of "economic" or "efficient" breach. See generally A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* (1979) (essay analyzing economics of contract remedies); R. POSNER, *supra* note 26, at 108 (requiring a breaching party to complete a breached contract often results in a waste of resources); Barton, *The Economic Basis of Damages for Breach of Contract, Damage Measures, and Economic*



courts have begun to recognize that in some cases a party may abuse the power to breach in some circumstances, resulting in unfavorable social consequences.<sup>31</sup> The creation of a tort action for breach of the implied covenant is judicial recognition that breach of some contracts is likely to conflict with public policy considerations.<sup>32</sup> Thus, the courts seek to deter parties from breaching certain contracts with the threat of the increased exposure of tort damages.<sup>33</sup> This idea is well-illustrated by the California insurance cases.

### A. The Insurance Cases

While California courts were not the first to recognize special duties of good faith in insurance contracts,<sup>34</sup> they often lead other states in rec-

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*Efficiency*, 24 RUTGERS L. REV. 273 (1970) (discussing economic theory of contract damages); Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract*, 1969 DUKE L.J. 49 (same). This "efficiency" approach is strongly criticized for ignoring the moral obligation to honor one's promises and for assuming an ability to measure the value of breach that exceeds the capabilities of the judicial process. See Polinsky, *Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law*, 87 HARV. L. REV. 1655, 1680-81 (1974). In addition, the efficiency argument often neglects to account for the transaction costs inherent in the resolution of disputes.

31. See R. POSNER, *supra* note 26, at 105-06.

32. See Louderback & Jurika, *supra* note 21, at 200-01. Actions for tortious breach originated in the insurance context. See *supra* text accompanying note 15. The features of insurance contracts, including its adhesionary aspects, the imbalance between the parties, the standardized terms unique to the industry, the insured's motivation for entering into the contract, and the nature of the service for which the contract provides render insurance contracts "particularly susceptible to public policy considerations." Louderback & Jurika, *supra* note 21, at 201.

33. See *supra* notes 22-24 and accompanying text.

34. The notion of the implied covenant imputing a heightened standard of care to certain contracts apparently was first expressed in *Brassil v. Maryland Casualty*, 210 N.Y. 235, 240-42, 104 N.E. 622, 624 (1914), which expressly relied on the implied covenant of good faith and fair dealing to provide a remedy for a dispute over attorneys' fees and costs. The *Brassil* court did not recognize a new tort cause of action, but dealt with the claim as a breach of contract case. *Id.* at 242, 104 N.E. at 624.

In later insurance abuse cases, plaintiffs asserted tort actions based upon theories of fraud, see, e.g., *Tiger River Pine v. Maryland Casualty*, 163 S.C. 229, 161 S.E. 491 (1931) (fraud and fiduciary duty); *Wisconsin Zinc v. Fidelity & Deposit Co.*, 162 Wis. 39, 53, 155 N.W. 1081, 1087 (1916) (same); cf. *Cleveland Wire Spring v. General Accident, Fire & Life Assurance Corp.*, 6 Ohio App. 344, 348 (1917) (considering a cause of action for bad faith viable); or theories of negligence, see, e.g., *Attleboro Mfg. v. Frankfort Marine, Accident & Plate Glass Ins.*, 240 F. 573 (1st Cir. 1917); *Attleboro Mfg. Co. v. Frankfort Marine, Accident & Plate Glass Ins.*, 171 F. 495 (C.C. Mass. 1909); *Douglas v. United States Fidelity & Guar.*, 81 N.H. 371, 374, 127 A. 708, 711 (1924); *Cavanaugh Bros. v. General Accident Fire & Life Assurance Corp.*, 79 N.H. 186, 106 A. 604 (1919); *G.A. Stowers Furniture v. American Indem.*, 15 S.W.2d 544, 547 (Tex. Ct. App. 1929).

The standards commonly applied to the insurer's duties to the insured generally followed two lines, either negligence or bad faith. See S. ASHLEY, *supra* note 19, §§ 2:04-2:05 (1984) (collecting cases).

ognizing these actions in other contexts.<sup>35</sup> Many jurisdictions have relied on California cases when shaping their own decisions in this area of the law.<sup>36</sup>

In the seminal case of *Comunale v. Traders & General Insurance*,<sup>37</sup> the defendant insurer was held liable for contract damages, yet the court noted that "wrongful refusal [to settle] has generally been treated as a tort."<sup>38</sup> A later case, *Crisci v. Security Insurance*,<sup>39</sup> relied on this dictum to justify a tort remedy for mental suffering caused by an insurer's wrongful refusal to settle a third-party claim against the insured.<sup>40</sup>

*Crisci* was significant because it applied tort damages<sup>41</sup> to a contract action. Furthermore, the *Crisci* court distinguished insurance contracts, where insureds seek "peace of mind and security," from ordinary commercial contracts, where the parties seek "commercial advantage."<sup>42</sup> This distinction subsequently formed the basis of the "special relationship" concept<sup>43</sup> that courts have used to extend tort liability for breach of the implied covenant beyond the insurance context.<sup>44</sup>

This shift in focus to the nature of the relationship between the parties allowed the court to reason that the duty of good faith and fair dealing was not found in the express or implied consent of the parties, but

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35. *Id.* § 2:16.

36. *Id.*

37. 50 Cal. 2d 654, 328 P.2d 198 (1958).

38. *Id.* at 663, 328 P.2d at 203 (dictum) (citing Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954) (suggesting that insurers' breach of contractual duties was treated as a tort; no rationale for tort liability was discussed in the article, nor was any rationale offered by the court in its decision)).

39. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

40. The *Crisci* court acknowledged that *Comunale* had applied contract damages, but distinguished the two cases noting the nonfeasance of the insurer in *Comunale*, 50 Cal. 2d at 659, 328 P.2d at 200 (*i.e.*, refusal to settle or defend amounting to denial of coverage) and the misfeasance in *Crisci*. "[T]he tort duty is ordinarily based on the insurer's assumption of the defense and of settlement negotiations . . ." *Crisci*, 66 Cal. 2d at 432 n.3, 426 P.2d at 178 n.3, 58 Cal. Rptr. at 18 n.3 (citations omitted); see *Comunale v. Traders & Gen. Ins.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 200 (1958).

41. Mental distress damages, normally unavailable in contract actions, were allowed pursuant to CAL. CIV. CODE § 3333 (West 1979). *Crisci*, 66 Cal. 2d at 432-34, 426 P.2d at 179, 58 Cal. Rptr. at 18-19.

42. *Id.* at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19. The court's reasoning is flawed because many insurance contracts, especially those with corporate insureds, are entered into for purely economic reasons. See Note, *The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts*, 56 S. CAL. L. REV. 1345, 1361 (1983).

43. See *Egan v. Mutual of Omaha Ins.*, 24 Cal. 3d 809, 819, 620 P.2d 141, 169, 169 Cal. Rptr. 691, 695-96 (1979).

44. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 768-69 & n.6, 686 P.2d 1158, 1166 & n.6, 206 Cal. Rptr. 354, 362 & n.6 (1984). See Comment, *supra* note 21, at 1294.

rather was implied in law in *every* contract.<sup>45</sup> This rationale imposed on the parties affirmative legal duties, whose breach is tortious.<sup>46</sup>

The California Supreme Court subsequently upheld the award of punitive damages for an insurer's breach of the implied covenant, on proof of malicious intent beyond bad faith.<sup>47</sup> While the court based its application of tort remedies on the nature of the parties' relationship, it nonetheless required "something more" than mere negligence or breach to impose punitive damages. Thus, in assessing damages, it held breach of the implied covenant to the same standard as any tort.<sup>48</sup>

The court's use of the "special relationship" to justify tort damages signalled an important shift in the rationale underlying traditional contract damages.<sup>49</sup> Courts have since used the insurance case "special relationship" analysis to extend tort actions for breach of the implied covenant to non-insurance contracts.<sup>50</sup> Several courts have extended tort actions to employment contracts<sup>51</sup> because employment contracts display

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45. *Gruenberg v. Aetna Ins.*, 9 Cal. 3d 566, 574, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 485 (1973); *Silberg v. California Life Ins.*, 11 Cal. 3d 452, 462, 521 P.2d 1103, 1109, 113 Cal. Rptr. 711, 717.

46. The insurer must consider the interest of the insured to be equal to its own. *Comunale v. Traders & General Ins.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 201. The standard governing insurer's consideration of the insured's interests is "whether a prudent insurer would have accepted the settlement offer if it alone were to be liable for the entire judgment." *Egan*, 24 Cal. 3d at 818, 620 P.2d at 145, 169 Cal. Rptr. at 695; *see also Austero v. National Casualty*, 84 Cal. App. 3d 1, 32, 148 Cal. Rptr. 653, 673 (1978) (by rejecting plaintiff's argument of strict liability for an erroneous decision regarding payment of disability benefits the court reaffirmed the reasonableness standard).

If the insurer fails to meet this standard, it is subject to tort liability. *Gruenberg*, 9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.

47. *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 922, 582 P.2d 980, 986 (1978). The court distinguished the bad faith relevant to liability for compensatory damages from the "oppression, fraud or malice" required by Cal. Civ. Code § 3294 (West 1979) precedent to the award of punitive damages.

48. *W. KEETON*, *supra* note 22, § 92; *supra* note 23 and accompanying text.

49. The court has used the implied covenant to justify the enforcement of specific, affirmative duties beyond the scope of the insurance contract. *Egan*, 24 Cal. 3d at 819, 620 P.2d at 146, 169 Cal. Rptr. at 695 (duty to investigate claims); *Silberg*, 11 Cal. 3d at 461-62, 521 P.2d at 1111, 113 Cal. Rptr. at 717 (duty to construe ambiguity in policy in manner that avoids severe detriment to the insured); *Spindle v. Travelers Ins.*, 66 Cal. App. 3d 951, 959, 136 Cal. Rptr. 404, 408 (1977) (duty to cancel policy only for justifiable reasons).

50. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 768-69 & n.6, 686 P.2d 1158, 1166 & n.6, 206 Cal. Rptr. 354, 362 & n.6 (1984) (dictum); *Commercial Cotton v. United California Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985); *Wallis v. Superior Court (Kroehler Mfg. Co.)*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984); *see also Dunfee v. Baskin Robbins*, 720 P.2d 1148 (Mont. 1986) (franchisees alleging breach of fiduciary duty, breach of implied covenant).

51. *Hudson v. Moore Business Forms*, 609 F. Supp. 467, 478 (N.D. Cal. 1985) *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987); *cf. Wallis*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (although dealing with a contract between an employer and its employee, *Wallis* is not a wrongful termination case).

the same characteristics that make the insurance contract relationship "special."<sup>52</sup>

## B. The Wrongful Termination Cases

In *Cleary v. American Airlines*,<sup>53</sup> the first employment case based on breach of the implied covenant of good faith and fair dealing, the plaintiff sued his former employer for wrongful discharge after he was terminated for "theft, leaving his work area . . . without authorization and threatening a fellow employee with bodily harm."<sup>54</sup> Acknowledging the existence of the implied covenant in the employment contract, the *Cleary* court identified two factors that justify a cause of action for breach of the implied covenant. First, the covenant operated as a function of *Cleary's* "longevity of service"; certain "benefits of the employment bargain . . . accrued during plaintiff's 18 years of employment."<sup>55</sup> Second, the employer had an "expressed policy . . . recogniz[ing] its responsibility to engage in good faith rather than in arbitrary conduct with respect to all of its employees."<sup>56</sup> The court explained that the employee had the burden of proving the termination was unjust, and the employer had the "opportunity to demonstrate that it did in fact exercise good faith and fair dealing" when it fired the plaintiff.<sup>57</sup>

Although consistent with the insurance cases, the court's precise reasoning linking longevity of service to the implied covenant is unclear. It is unlikely that the court meant to apply the implied covenant only to employees exhibiting longevity of service, since it suggested that the duty created by the covenant existed in every contract.<sup>58</sup> Subsequent cases

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52. *Seaman's*, 36 Cal. 3d at 769 n.6, 686 P.2d at 1166 n.6, 206 Cal. Rptr. at 362 n.6 (dictum); *Wallis*, 160 Cal. App. 3d at 1116 n.2, 207 Cal. Rptr. at 127 n.2; *Gates v. Life of Montana*, 205 Mont. 304, 304, 668 P.2d 213, 214 (1983).

One California court has denied the assertion of a tort cause of action because the "special relationship" element was lacking. *Quigley v. Pet, Inc.*, 162 Cal. App. 3d 890, 893, 208 Cal. Rptr. 394, 403 (1984); see *Louderback & Jurika*, *supra* note 21, at 220-27; Comment, *supra* note 21, at 1298-1301.

53. 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980).

54. *Id.* at 447, 168 Cal. Rptr. at 724.

55. *Id.* at 455, 168 Cal. Rptr. at 729 (emphasis added). The court held that "[t]ermination of employment without legal cause after such a period of time offends the implied covenant." *Id.* In a subsequent case, the California Supreme Court defined "just cause" to be "a fair and honest cause or reason, regulated by good faith in the part of the party exercising the power." *Pugh v. See's Candies*, 116 Cal. App. 3d 311, 330, 171 Cal. Rptr. 917, 928 (1981) (citation omitted).

56. *Cleary*, 111 Cal. App. 3d at 455, 168 Cal. Rptr. at 729 (emphasis added). This language is reminiscent of *Comunale*, in which the court found that insurer had violated an express policy obligation. See *Comunale v. Traders & Gen. Ins.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 200 (1958).

57. *Cleary*, 177 Cal. App. 3d at 456, 168 Cal. Rptr. at 729.

58. In its general remarks, the court endorsed the "unconditional and independent" duty created by the implied covenant in "every contract." *Id.* at 453, 168 Cal. Rptr. at 728.

suggest that the *Cleary* court's emphasis on longevity was simply one way a court could determine whether the "special relationship" existed to justify the action for tortious breach of the implied covenant.<sup>59</sup>

Since *Cleary*, a number of cases have held for the employee on grounds of the implied covenant of good faith and fair dealing.<sup>60</sup> These cases differ as to the specific criteria to be applied<sup>61</sup> and the basis for liability.<sup>62</sup> At the same time, there are strong indications that the cause of action is based primarily on the "special relationship" concept. Several courts have used the "special relationship" criteria to extend and limit tort remedies for breach of the implied covenant in the employment contract.<sup>63</sup> Amidst commentators' support<sup>64</sup> and criticism<sup>65</sup> California

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59. Several courts have since concluded that lengthy satisfactory service, although "extremely helpful" to an employee seeking to state a cause of action for employer's breach of the implied covenant, is "not essential to the cause of action." *Gray v. Superior Ct.*, 181 Cal. App. 3d 813, 821, 226 Cal. Rptr. 570, 573-74 (1986) (citing *Shapiro v. Wells Fargo Realty Advisors*, 152 Cal. App. 3d 467, 478-79, 199 Cal. Rptr. 613, 619 (1984)); *Crosier v. United Parcel Serv.*, 150 Cal. App. 3d 1132, 1137, 198 Cal. Rptr. 361, 363-64 (1983). *But see* *Foley v. Interactive Data Corp.*, 184 Cal. App. 3d 241, 222 Cal. Rptr. 740, 712 P.2d 891 (1986) (longevity of employment is necessary for an action for breach of the implied covenant of good faith and fair dealing); *Morriss v. Coleman*, 241 Kan. 501, 738 P.2d 841 (1987) (court declined to apply the implied covenant of good faith and fair dealing to employment-at-will contracts); *Hillesland v. Federal Land Bank Ass'n*, 407 N.W.2d 206 (N.D. 1987) (court declined to apply the implied covenant of good faith and fair dealing to employment contracts with no term of duration of employment).

60. *See supra* note 10.

61. *Rulon-Miller v. IBM.*, 162 Cal. App. 3d 241, 249, 208 Cal. Rptr. 524, 529 (1984) (express company policy); *Wallis v. Superior Court (Kroehler Mfg. Co.)*, 160 Cal. App. 3d 1109, 1120, 207 Cal. Rptr. 123, 129 (1984) (special relationship); *Cleary*, 111 Cal. App. 3d at 456, 168 Cal. Rptr. at 729 (longevity).

62. *Koehrer v. Superior Court*, 181 Cal. App. 3d 1155, 226 Cal. Rptr. 820 (1986) (bad faith denial of contract); *Fortune v. National Cash Register*, 373 Mass. 96, 364 N.E.2d 1251 (1977) (public policy reasons).

63. *Miller v. Fairchild Indus.*, 797 F.2d 727, 736 (9th Cir. 1986); *Hudson v. Moore Business Forms*, 609 F. Supp. 467, 479 (N.D. Cal. 1985), *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987); *Clutterham v. Coachmen Indus.*, 169 Cal. App. 3d 1223, 1228, 215 Cal. Rptr. 795, 797 (1985); *Gomez v. Volkswagen of Am.*, 169 Cal. App. 3d 921, 928, 215 Cal. Rptr. 507, 512 (1985); *Khanna v. Microdata Corp.*, 170 Cal. App. 3d 250, 263, 215 Cal. Rptr. 860, 867 (1985); *Gianelli Distrib. Co. v. Beck & Co.*, 172 Cal. App. 3d 1020, 1036, 219 Cal. Rptr. 203, 209 (1985); *Wayte v. Rollins Int'l, Inc.*, 169 Cal. App. 3d 1, 21, 215 Cal. Rptr. 59, 70-71 (1985); *Rulon-Miller v. IBM*, 162 Cal. App. 3d 241, 248, 208 Cal. Rptr. 524, 529 (1984).

64. *See* *Louderback & Jurika, supra* note 21, at 189 (when the *Wallis* criteria are present, "public policy considerations, the foundation for tort action, become operative and the tort of bad faith breach of contract should be recognized"); Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Serv. v. Standard Oil Co.*, 69 MINN. L. REV. 1161, 1177-84 (1985) (identifying the "three distinguishing characteristics of the insurance context" justifying tort remedies as "the quasi-public-service nature of the insurance industry, the use of adhesion contracts resulting from the disproportionate bargaining power of the insurer over the insured, and the fiduciary quality of the insurer's relationship with the insured." (footnotes omitted)); Comment, *The Covenant of Good Faith Dealing: A Common Ground for the Torts of*

courts have freely extended the insurance "special relationship" model to the employment relationship.<sup>66</sup>

### C. The Special Relationship Model

In *Tameny v. Atlantic Richfield Co.*,<sup>67</sup> the California Supreme Court cited the California insurance cases and suggested the possibility of a similar implied covenant action in the employment context.<sup>68</sup> In a non-employment case,<sup>69</sup> the court later noted that the availability of a tort action for breach of the implied covenant in insurance cases has depended on the "special relationship between insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility . . . [O]ther relationships with similar characteristics deserv[e] similar legal treatment."<sup>70</sup>

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*Wrongful Discharge From Employment*, 21 SANTA CLARA L. REV. 1111, 1143-48 (1981) [hereinafter Comment, *The Covenant of Good Faith Dealing*] (noting that while the insurance and employment relationships are not identical, "[m]any of the factors that led the courts to impose duties on insurers are also present in the employment relationship.").

65. See Comment, *supra* note 21, at 1299-1301 (link between "special relationships" and tort liability is "analytically questionable"; because the purpose of tort damages is to punish socially unreasonable conduct, recovery of tort damages should therefore focus on conduct, rather than the nature of the relationship); Note, *Defining Public Policy Torts in At-Will Dismissals*, 34 STAN. L. REV. 153, 165-67 (1981) ("factors justifying the public policy tort approach in the insurance company cases either do not exist in the employment relationship or appear there in weaker form").

66. Virtually all of the wrongful termination decisions applying a tort cause of action to breach of the implied covenant either expressly state the *Wallis* criteria or cite the same insurance cases as a basis for its application. See, e.g., *Gray v. Superior Court*, 181 Cal. App. 3d 813, 821, 226 Cal. Rptr. 570, 574 (1986); *Khanna v. Microdata Corp.*, 170 Cal. App. 3d 250, 262 n.2, 215 Cal. Rptr. 860, 866 n.2 (1985).

67. 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980). *Tameny* was decided on the basis of California's wrongful discharge doctrine, which assures that an employee's refusal to violate the law in opposition to company orders will not result in discharge. *Id.* at 178, 610 P.2d at 1336-37, 164 Cal. Rptr. at 846. The court based its ruling on the "public policy considerations" expressed in *Petermann v. International Bhd. of Teamsters*, 174 Cal. App. 2d 184, 188, 344 P.2d 25, 27 (1959) (employer's authority to discharge for refusal to commit perjury limited by concern for public interest in general compliance with penal system), and thus found it "unnecessary" to address the implied covenant issue. *Tameny*, 27 Cal. 3d at 180 n.12, 610 P.2d at 1337 n.12, 164 Cal. Rptr. at 846 n.12.

68. *Id.*

69. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984). Before allowing plaintiff to develop a marina in Eureka, California, the city required it to secure a dealership for marine fuel. Seaman's negotiated with Standard Oil and obtained a letter of intent from Standard to that effect. Standard repudiated the letter, for which Seaman's sued for breach of contract, intentional interference with contractual relations, and breach of the implied covenant. Although the majority discussed extensively the implied covenant, it instead created the tort of "bad faith denial" of contract and approved the award of tort damages. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

70. *Id.* at 768-69, 686 P.2d at 1166, 206 Cal. Rptr. at 362. The court noted that the employment relationship has "some of the same characteristics as the relationship between insurer and insured." *Id.* at 769 n.6, 686 P.2d at 1166 n.6, 206 Cal. Rptr. at 362 n.6.

An appellate court applied the "special relationship" model in *Wallis v. Superior Court*,<sup>71</sup> extending the tort of breach of the implied covenant to a contract between an employer and its former employee.<sup>72</sup> Although the *Wallis* contract was not an employment contract, it was a contract entered into between an employer and its employee in the context of the employment relationship. In *Wallis*, the employer promised to pay a monthly stipend to its former employee for ten years, during which time the employee's accrued pension benefits would remain unavailable. In exchange for these payments, the employee agreed not to compete with his former employer's business. The employee received payments according to the contract for almost three years, until the employer unilaterally terminated what it referred to as "gratuitous payments."<sup>73</sup> The court, in an extensive analysis, determined that the characteristics of the insurance contract that give rise to a tort action are "also present in most employer-employee relationships."<sup>74</sup>

The court noted that the features that justify tort remedies and distinguish insurance contracts from ordinary commercial contracts are "characteristics with public policy implications,"<sup>75</sup> including a non-profit motivation for entering into the contract,<sup>76</sup> disparity in bargaining power,<sup>77</sup> and the inadequacy with which contract damages promote policy concerns.<sup>78</sup>

These features create the "special relationship between the parties which requires a heightened duty on the part of the insurer not to breach the covenant of good faith and fair dealing implicit in its contract, as well as a heightened expectation by the insured that his or her contract will not be breached."<sup>79</sup> This "heightened expectation" derives from the duty described in earlier cases requiring an insurer to consider the insured's interest as equal to its own.<sup>80</sup> Using these concepts as a basis for analysis, the *Wallis* court identified five factors that must be present in a con-

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71. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

72. *Id.* at 1116, 207 Cal. Rptr. at 127.

73. *Id.* at 1113, 207 Cal. Rptr. at 125.

74. *Id.* at 1116 n.2, 207 Cal. Rptr. at 127 n.2.

75. *Id.* at 1117, 207 Cal. Rptr. at 128 (citing *Crisci v. Security Ins.*, 66 Cal. 2d 425, 434, 426 P.2d 173, 179, 58 Cal. Rptr. 13, 19 (1967) (insureds expect "peace of mind" when purchasing insurance)).

76. *Crisci*, 66 Cal. 2d at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19; *Wallis*, 160 Cal. App. 3d at 1117-18, 207 Cal. Rptr. at 128.

77. *Wallis*, 160 Cal. App. 3d at 1117-18, 207 Cal. Rptr. at 128 (noting that the normal protections provided by the open market are not available in the insurance context).

78. *Id.* (contract damages provide no incentive to the insurer not to breach; if liable only for the contract limits, insurer will find it economically advantageous to withhold payment and earn interest during which time the insured is forced to accept a settlement below policy limits).

79. *Id.* at 1118, 207 Cal. Rptr. at 128-29.

80. *Id.* at 1118, 207 Cal. Rptr. at 129 (citation omitted). Chief Justice Bird developed the same line of reasoning in *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752,

tract to "predicate" tort liability: (1) the contracting parties' bargaining positions must be inherently unequal; (2) one party must be motivated by "non-profit" concerns such as security or peace of mind; (3) contract damages must be inadequate because they do not create accountability of the superior party and they do not make the inferior party "whole"; (4) one party must be particularly vulnerable because of the type of harm it could suffer and because it must trust the other party to perform; and (5) the stronger party must be aware of this vulnerability.<sup>81</sup> The existence of these factors creates a "heightened duty" on the part of the stronger party "not to act unreasonably in breaching the contract, and to consider the interest of the [weaker] party as tantamount to its own."<sup>82</sup>

Once a court determines that a "special relationship" exists, it may impute a higher standard of conduct to the "superior" party, consistent with the expectations of the "inferior" party.<sup>83</sup> Whatever affirmative duties<sup>84</sup> are created in the context of the particular relationship at issue depends on the nature of that relationship.<sup>85</sup>

An employee may stand in a "special relationship" to his employer and, thus, faces a "heightened duty" not to "act unreasonably" and to consider the employer's interest as tantamount to his own.<sup>86</sup> In determining when such a duty might exist, it is instructive to consider the common-law duties traditionally imputed to the employee.

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776-82, 686 P.2d 1158, 1170-77, 206 Cal. Rptr. 354, 368-71 (Bird, C.J., dissenting in part and concurring in part).

81. *Wallis*, 160 Cal. App. 3d at 1118, 207 Cal. Rptr. at 129.

82. *Id.* The court applied the facts of the case to the test it developed, and determined that the employer had a duty not to act unreasonably in discontinuing contract payments, and was therefore subject to tort liability.

83. The characteristics of the "special" employment relationship "undoubtedly help shape the justified expectations of the contracting parties, and therefore, help determine the nature and extent of the duty of good faith between them." *Seaman's*, 36 Cal. 3d at 777, 686 P.2d at 1171, 206 Cal. Rptr. at 368 (Bird, C.J., dissenting in part and concurring in part) (citation omitted).

84. Conduct deemed to tortiously breach the implied covenant includes termination without just cause, *Cleary v. American Airlines*, 111 Cal. App. 3d 443, 457, 168 Cal. Rptr. 722, 729 (1980); termination for bringing suit against the employer, *Khanna v. Microdata*, 170 Cal. App. 3d 250, 265, 215 Cal. Rptr. 860, 868 (1985); and application of company policy in a discriminatory or arbitrary fashion, *Rulon-Miller v. IBM*, 162 Cal. App. 3d 241, 248, 208 Cal. Rptr. 524, 529 (1984).

85. *Id.*; *Wallis*, 160 Cal. App. 3d at 1118-20, 207 Cal. Rptr. at 128-29. *Contra Khanna*, 170 Cal. App. 3d at 263, 215 Cal. Rptr. at 867 (requiring bad faith denial of contract); *Shapiro v. Wells Fargo Realty Advisors*, 152 Cal. App. 3d 467, 478-79, 199 Cal. Rptr. 613, 619 (1984) (requiring "bad faith action extraneous to the contract, combined with obligor's intent to frustrate obligee's enjoyment of contract rights"); *Crozier v. United Parcel Serv.*, 150 Cal. App. 3d 1132, 1138, 198 Cal. Rptr. 361, 364 (1983) (endorsing *Cleary's* longevity requirement).

86. *Comunale v. Traders Gen. Ins.*, 50 Cal. 2d 654, 658, 328 P.2d 198, 200 (1958).



## II. Employees' Common-Law Good Faith Duties

In addition to the duties expressly imposed on or undertaken by the employee in the employment contract, the law implies various obligations on him. These implied duties include: exercise of competence and care in the performance of his duties,<sup>87</sup> obedience to reasonable rules,<sup>88</sup> decent conduct,<sup>89</sup> loyalty while in the employer's service,<sup>90</sup> and treatment of the employer with respect.<sup>91</sup> These duties are implied absent an express contract. Further, during the tenure of his employment, equity prevents an employee from using his employer's trade secrets and confidential information for his own benefit or for the benefit of someone other than his employer,<sup>92</sup> and may prevent him from competing with his former employer.<sup>93</sup>

Compared to an employee, an agent's duties represent a higher standard of conduct.<sup>94</sup> An agent's implied duties include: good faith and

87. See 53 AM. JUR. 2D *Master and Servant* § 108 (1970) and cases cited therein. In addition, the employee is bound to indemnify the employer for damages resulting from failure to perform the duty that he owes to the employer. *American S. Ins. v. Dime Taxi Serv.*, 275 Ala. 51, 55, 151 So. 2d 783, 785 (1963); *Gadsen v. George H. Crafts & Co.*, 175 N.C. 358, 363, 95 S.E. 610, 612 (1918).

88. 53 AM. JUR. 2D *Master and Servant* § 98 (1970) and cases cited therein. Failure to follow the employer-principal's instructions will render the employee-agent liable for any damages caused by the employee's actions beyond the scope of the principal-employer's instructions. See 3 AM. JUR. 2D *Agency* §§ 206-44 (1986).

89. *Lyon v. Pollard*, 87 U.S. (20 Wall.) 403, 406 (1874); *Murmanill Corp. v. Simkins*, 251 F.2d 33, 35 (5th Cir. 1958); *Twentieth Century-Fox Film Corp. v. Lardner*, 216 F.2d 844, 850 (9th Cir. 1954), *cert. denied*, 348 U.S. 944, *reh'g denied*, 348 U.S. 965 (1955).

90. *Coker v. Wesco Materials Corp.*, 368 S.W.2d 883, 884 (Tex. Ct. App. 1963); *Community Counselling Serv., Inc. v. Reilly*, 317 F.2d 239, 244 (4th Cir. 1963); *United Bd. & Carton Corp. v. Britting*, 63 N.J. Super. 517, 522, 164 A.2d 824, 828 (1959), *modified on other grounds*, 61 N.J. Super. 340, 160 A.2d 660, *cert. denied*, 33 N.J. 326, 164 A.2d 379 (1960).

91. *NLRB v. Montgomery Ward & Co.*, 157 F.2d 486, 496 (8th Cir. 1946).

92. RESTATEMENT OF TORTS § 757 (1934); see also Robison, *The Confidence Game: An Approach to the Law About Trade Secrets*, 25 ARIZ. L. REV. 347, 374 (1983) (discussing the extent of an employee's duty not to disclose or use trade secrets); Note, *A Balanced Approach to Employer-Employee Trade Secret Disputes in California*, 31 HASTINGS L.J. 671, 673 (1980) (discussing contractual agreements in which the employee agrees not to disclose or use the employer's trade secrets).

93. Competition with one's former employer is barred at common law when the former employee competes in a fraudulent manner, violates an enforceable anticompetitive covenant, or misappropriates trade secrets. See 54 AM. JUR. 2D *Monopolies* §§ 542-64 (1971) (*Monopolies, Restraints of Trade, and Unfair Trade Practices*).

94. The distinctions between agent and employee, and between principal and employer are important in determining the rights and duties correspondent to the respective party's status. *Dean v. Ketter*, 328 Ill. App. 206, 211, 65 N.E.2d 572, 574 (1946) (distinguishing between an independent contractor and an ordinary employee); *Anderson v. St. Paul*, 226 Minn. 186, 196, 32 N.W.2d 538, 544 (1948) (distinguishing between an ordinary employee, such as a waitress, and a managing agent).

An employee can be an agent with respect to some elements of his job, and a servant with respect to others. *Lynch v. Walker*, 159 Fla. 188, 190, 31 So. 2d 268, 270-71 (1947); *Kourik v.*

loyalty,<sup>95</sup> adherence to instructions,<sup>96</sup> exercise of reasonable care in the performance of her obligations,<sup>97</sup> and accountability for all funds and property belonging to the principal.<sup>98</sup> General duties implied in law require the agent to conduct herself with propriety.<sup>99</sup> If the agent's services include personal relations with her principal, she has a duty to act so that continued friendly relations with her principal are not rendered impossible.<sup>100</sup>

Because of the authority vested in the agent by her principal, the agency relationship demands trust and confidence.<sup>101</sup> This "special relationship" creates quasi-fiduciary duties on the part of the agent.<sup>102</sup> When the agency relationship is one of employment, courts have found that the fiduciary duty requires that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract."<sup>103</sup>

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English, 340 Mo. 367, 377, 100 S.W.2d 901, 905 (1936), depending on the nature of the performance required by the contract. A principal distinction between the functions of agent and employee is that of authority. The agent is authorized to enter into legal relations with third parties; an employee has no such authority, but renders services that are purely mechanical at the direction of his employer. *Dimos v. Stowe*, 193 Va. 831, 839, 71 S.E.2d 186, 190 (1952).

95. See *infra* notes 107-21 and accompanying text.

96. *Appleby v. Kewanee Oil*, 279 F.2d 334, 336 (10th Cir. 1960) (right of principal to give lawful directions that agent is under duty to obey).

97. 3 C.J.S. *Agency* § 297 (1973).

98. *United States v. Rose*, 346 F.2d 985, 990 (3d Cir. 1965), *cert. denied sub nom. Aetna Ins. v. United States*, 382 U.S. 979 (1966); *Brooke v. Quigley*, 33 Cal. App. 484, 491, 165 P. 731, 734 (1917).

99. *United Radio v. Cotton*, 61 Ohio App. 247, 252, 22 N.E.2d 532, 534 (1938); see also RESTATEMENT (SECOND) OF AGENCY § 380 (1958) (duty of good conduct).

100. *Meyers v. American Well Works*, 114 F.2d 252, 253 (4th Cir. 1940) (plaintiff's contract to act as defendant's exclusive sales agent subject to the implied condition that employee's conduct towards his employer shall minimally be free of "insolence, disrespect, and insubordination"), *cert. denied*, 313 U.S. 563 (1941).

101. By extending its authority to the employee, the employer necessarily places itself in a position of trust. See *infra* notes 122-29 and accompanying text. This element of necessity and trust is one of the elements referred to by the courts as a "predicate to tort liability" for insurers and employers. *Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984).

102. While not lending itself to precise definition, the fiduciary relationship operationally prohibits the stronger party from abusing its power when it seeks to promote its own interests at the expense of the weaker party. See *First Bank of Wakeeney v. Moden*, 235 Kan. 260, 262, 681 P.2d 11, 13 (1984).

Commentators have criticized this expression. See *Sullivan, supra* note 29, at 229 n.119 ("Phrases such as fiduciary relationship, relationship of trust, and confidential relationship are used interchangeably by the courts; the definition of these terms is also vague, haphazard, and fragmentary." (citation omitted)); Comment, *The Covenant of Good Faith Dealing, supra* note 64, at 1147-48 ("fiduciary" expresses the conclusion that the law will protect the weaker party by imposing a standard of care higher than the usual duty of good faith requires).

103. *Nelson v. Abraham*, 29 Cal. 2d 745, 751, 177 P.2d 931, 934 (1947) (quoting *Kirke La Shelle v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933)); *Van Valkenburgh*,

The trust element of good faith duties is associated with the very meaning of fiduciary.<sup>104</sup> The fiduciary relationship exists when "the parties are so circumstanced or associated in a business transaction that one party must rely on the good faith and integrity of the other."<sup>105</sup>

A review of the "disloyalty" and "trade secrets" cases illustrates the "good faith" quality of common-law duties traditionally imputed to certain employees and makes clear that the idea of employees assuming heightened responsibilities in "special relationship" situations is by no means a new or revolutionary concept. Just as the "special relationship" heightens the expectations of insureds and employees in the context of their respective relationships, an employer's expectations are heightened when an employee assumes duties with fiduciary qualities. In such situations, the employee is traditionally held to a higher standard of conduct<sup>106</sup> than employees without quasi-fiduciary duties.

### A. Duty of Good Faith and Loyalty

The duty of good faith and loyalty requires the agent-employee to act for the furtherance and advancement of his employer's interests.<sup>107</sup> Most often this means that the employee will not compete with his em-

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Nooger & Neville, Inc. v. Hayden Publishing Co., 30 N.Y.2d 34, 39, 281 N.E.2d 142, 144, 330 N.Y.S.2d 329, 333, *cert. denied*, 409 U.S. 875 (1972).

Noting that this is the precise definition of the implied covenant of good faith and fair dealing found in every contract, one commentator concluded that the term "fiduciary" says nothing about the characteristics leading the court to impose the good faith duties that flow from it. Comment, *The Covenant of Good Faith Dealing*, *supra* note 64, at 1147.

104. Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 800 n.17 (1983).

105. *Stevens v. Marco*, 147 Cal. App. 2d 357, 372, 305 P.2d 669, 678 (1956). The *Wallis* court considered the same "vulnerability" factor to be a "predicate" for tort liability in an implied covenant breach. See *supra* note 82 and accompanying text.

106. The difference between an agent's duties and an employee's duties is illustrated by the difference in initiative required by the law. An agent must take the initiative to act. *British Gen. Ins. v. Simpson Sales*, 265 Ala. 683, 688, 93 So. 2d 763, 767 (1957) (insurance agent liable for failure to inform insured that agent was unable to write policies to cover different home); *D'Acquisto v. Evola*, 90 Cal. App. 2d 210, 214, 202 P.2d 596, 598 (1949) (broker not liable for failure to ascertain grade and size of fish purchased for principal, although duty to ascertain grade generally would create liability); *Render & Hammett v. Hartford Fire Ins.*, 33 Ga. App. 716, 719, 127 S.E. 902, 903 (1925) (agent liable for failure to notify principal of substitute notice served upon agency in lieu of service on principal).

These duties stand in contrast to the employee's duty simply to follow directions. See generally 53 AM. JUR. 2D *Master and Servant* §§ 97-98 (1970) (employee's duty to employer).

107. *United States v. Drumm*, 329 F.2d 109, 112 (1st Cir. 1964) (poultry inspector, as agent of U.S. government, can breach fiduciary duties by engaging in independent consulting contracts); *Knudsen v. Torrington Co.*, 254 F.2d 283, 286 (2d Cir. 1958) (partnership as sales agency); *Valley Nat'l Bank v. Milmo*, 74 Ariz. 290, 297, 248 P.2d 740, 744 (1952) (bank as agent for mortgagee); *Collins v. Heitman*, 225 Ark. 666, 671, 284 S.W.2d 628, 633 (1955) (auctioneer as agent for both buyer and seller); *McKinney v. Christmas*, 143 Colo. 361, 363, 353 P.2d 373, 374 (1960) (real estate broker as agent for landowners); *Blanchard v. Lewis*, 414 Ill. 515, 522, 112 N.E.2d 167, 172 (1953) (securities brokers as agents for bondowner).

ployer.<sup>108</sup> The duty of loyalty also has forbidden reduction in productivity,<sup>109</sup> contravention of employer's orders,<sup>110</sup> or misappropriation of "some special knowledge" gained from employment.<sup>111</sup>

Employer's remedies for employee's breach of the duty of loyalty include compensatory damages,<sup>112</sup> and occasionally punitive damages.<sup>113</sup> The principal reason for awarding compensatory damages is to reimburse the employer for provable losses caused by the employee's breach of loyalty.<sup>114</sup> Courts have awarded punitive damages where the circumstances demonstrate "tort elements and abuse of confidence."<sup>115</sup> Most breach of loyalty cases, however, seek injunctive relief.<sup>116</sup>

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108. *Duane Jones Co. v. Burke*, 306 N.Y. 172, 188, 117 N.E.2d 237, 245 (1954); *Goal Systems Int'l v. Klouda*, No. 84AP-168, (Ohio App. Oct. 10, 1985) ("an employee is . . . in breach of his duty of loyalty if he competes with his employer").

109. *Westwood Chem. Co. v. Kulick*, 570 F. Supp. 1032, 1040 (S.D.N.Y. 1983) (on employer's proof that employees "decreased the work they did for" employer while engaging in activities extraneous to their employment contracts, employees found in breach of their "duties of good faith and fair dealing") (citing *Duane Jones*, 306 N.Y. at 189, 117 N.E.2d at 245; *Elco Shoe Mfrs. v. Sisk*, 260 N.Y. 100, 104, 183 N.E. 191, 192 (1932) (rejecting salesman's defense that cheaper line of shoes did not technically "compete" with plaintiff's "higher-end" product, court focused on principal's expectation that all of its salesmen's efforts be directed towards sale of its products)).

110. *Breen v. Larson College*, 137 Conn. 152 (1950). The dean of a private college was discharged for unilaterally inviting local police on campus to investigate a student-reported rape, in direct contravention of his employer's instructions. Rejecting plaintiff's plea for reinstatement, the *Breen* court found that his breach of the duty of good faith and loyalty was "sufficient basis . . . to justify [the lower court's] conclusion that he had breached the contract [and that] employer's action terminating [employment] . . . was valid." *Id.* at 157.

In *Breen*, the grounds for breach of the duty of loyalty were the employer's belief that the publicity following the police investigation was detrimental to the college's interests. *Id.* at 156. The court made no attempt to evaluate the merits of the president's decision and simply held that breach of the implied condition of loyalty was a breach of contract, and excused the employer from performing its contract duties.

111. *Westwood*, 570 F. Supp. at 1040.

112. *Frederick Chusid & Co. v. Marshall Leeman & Co.*, 326 F. Supp. 1043, 1060 (S.D.N.Y. 1971).

113. *Id.* at 1060. The court awarded punitive damages in the amount of \$1,500 to a former employer for its former employee's breach of the duty of loyalty, in the absence of a showing of actual damages resulting from the breach. Noting the departure from normal contract damages rules, the court justified its award of punitive damages by emphasizing the "tort elements and abuse of confidence—the disloyalty of employees." The breach of loyalty in this case consisted of defendants, former employees of plaintiff, soliciting current employees to leave plaintiff while in its employ. *Id.*; see also *Duane Jones Co. v. Burke*, 306 N.Y. 172, 192, 117 N.E.2d 237, 247 (1954) (amount of damages could not be estimated with certainty).

114. Compensatory damages include reimbursement of wages paid during period of employment when employee was being disloyal, and the cost of training employees that replaced those "hired away" by former employee. *Chusid*, 326 F. Supp. at 1061 (citing *Harry R. Deffler Corp. v. Kleeman*, 19 A.D.2d 396, 404, 243 N.Y.S.2d 930, 938 (1963), *aff'd*, 19 N.Y.2d 694, 278 N.Y.S.2d 883, 225 N.E.2d 569 (1967)).

115. *Id.* at 1060 (citing 5 A. CORBIN, CORBIN ON CONTRACTS § 1077, at 439-46 (1964)).

116. *Universal Elec. v. Golden Shield Corp.*, 316 F.2d 568, 573 (1st Cir. 1963) (citing *Midland-Ross v. Yokana*, 293 F.2d 411, 412 (3d Cir. 1961)); *Breen v. Larson College*, 137

Some courts have broadly stated that an "act contrary to the employer's interests" is a breach of the duty of good faith and loyalty.<sup>117</sup> This language is strikingly similar to language used to define the implied covenant.<sup>118</sup> This similarity suggests that the same kind of "special relationship" considerations that prompted courts to impose the duty of good faith and fair dealing on insurance companies and employers have historically been used by courts to impose liability on employees for breach of the duty of good faith and loyalty.

Elements similar to those found in an employer's breach of the implied covenant are also found in an employee's breach of the duty of loyalty. These include the employee's duty to consider the employer's interest equally to his own,<sup>119</sup> the special trust elements that create heightened duties,<sup>120</sup> and the employer's heightened expectations in the employee's standard of conduct.<sup>121</sup>

## B. Non-Disclosure of Trade Secrets

A duty closely related to loyalty is that of nondisclosure of trade secrets or confidential information. An employee is considered a fiduci-

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Conn. 152, 157 (1950); *Auxton Computer Enter., Inc. v. Parker*, 174 N.J. Super. 418, 425, 416 A.2d 952, 956 (1980); *Elco Shoe Mfrs. v. Sisk*, 260 N.Y. 100, 105, 183 N.E. 191, 192 (1932); see Note, *Tort Remedy for Bad Faith Breaches of Intracorporate Fiduciary Duty*, 16 PAC. L.J. 853, 854 (1985).

117. *Midland-Ross Corp. v. Yokana*, 293 F.2d 411, 412 (3d Cir. 1961) (At common law the employee owes a duty of loyalty to his employer. "He must not, while employed, act contrary to the employer's interests and, in general terms, owes a duty of loyalty as on of the incidents of the employer-employee relationship."); accord *Universal Elec. v. Golden Shield Corp.*, 316 F.2d 568, 573 (1st Cir. 1963).

This expansive reading of the duty of loyalty illustrates the imbalance in bargaining power that the tort action of employer's breach of the implied covenant is perhaps intended to equalize. See Tobriner & Grodin, *The Individual and the Public Service Enterprise in the New Industrial State*, 55 CALIF. L. REV. 1247 (1967); Tobriner, *Retrospect: Ten Years on the California Supreme Court*, 20 UCLA L. REV. 5 (1972).

118. *Universal Elec. v. Golden Shield Corp.*, 316 F.2d 568, 573 (1st Cir. 1963) (citing *Midland-Ross Corp. v. Yokana*, 293 F.2d 411, 412 (3d Cir. 1961)); *Breen v. Larson College*, 137 Conn. 152, 157 (1950) (violation of trust equated with breach of the "implied condition that the [employee] . . . will do nothing injurious to his employer's interest."); *Auxton Computer Enter. v. Parker*, 174 N.J. Super. 418, 425, 416 A.2d 952, 956 (1980) ("employee owes a duty of loyalty to the employer, and . . . must not, while employed, act contrary to employer's interests."); cf. *Comunale v. Traders & Gen. Ins.*, 50 Cal. 2d 654, 658, 328 P.2d 198, 200 (1958) (all contracts contain implied covenant that neither party will do anything that injures the right of the other to receive the benefits of the agreement); *Brown v. Superior Court*, 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949) (same).

119. *Bull v. Logetronics, Inc.*, 323 F. Supp. 115, 133 (E.D. Va. 1971).

120. Interference with at-will employment relationships, while normally not actionable, is "actionable . . . when . . . there is a relation of confidence." *Frederick Chusid & Co. v. Marshall Leeman & Co.*, 326 F. Supp. 1043, 1060 (S.D.N.Y. 1971) (citing *A.S. Rampell, Inc. v. Hyster Co.*, 3 N.Y.2d 369, 165 N.Y.S.2d 475, 144 N.E.2d 371 (1957)).

121. *Elco Shoe Mfrs. v. Sisk*, 260 N.Y. 100, 101, 183 N.E. 191, 192 (1932).

ary with respect to the information that comes to him in the course of his employment.<sup>122</sup> This relationship requires him to exercise the utmost good faith, loyalty, and honesty to his employer.<sup>123</sup> Thus, when an employee works with trade secrets, he must exercise a standard of conduct higher than that of employees who never work with trade secrets.<sup>124</sup>

Even in the absence of express contractual provisions,<sup>125</sup> when an employee holds a position of trust<sup>126</sup> a number of courts have implied the duty to protect confidential information. This position of trust exists whenever an employee is entrusted with confidential information.<sup>127</sup> Firms using sensitive information in their operations often must disclose it to their employees so that employees can perform their jobs.<sup>128</sup> This

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122. See *Community Counselling Serv. Inc. v. Reilly*, 317 F.2d 239, 244 (4th Cir. 1963); *Bull v. Logetronics, Inc.*, 323 F. Supp. 115, 132 (E.D. Va. 1971).

123. *Logetronics*, 323 F. Supp. at 132.

124. The court used the trade secrets doctrine to justify its application of tort liability and the higher standard of conduct required in fiduciary relationships. *Logetronics*, 323 F. Supp. at 132-33.

125. In many cases today involving the improper use of trade secrets, the employee has explicitly agreed not to use or disclose confidential information for a certain period of time. See, e.g., *Rollins Protective Serv. Co. v. Palermo*, 249 Ga. 138, 140-42, 287 S.E.2d 546, 549-51 (1982) (contract prohibiting employee from disclosing methods and systems of alarm systems for two years).

The increased use of interoreem, or noncompetition clauses in employment contracts is evidenced by the increase in recent years of the number of claims based upon violation of these agreements. A Lexis search conducted on 11/24/86 retrieved 78 cases based on actions for violation of noncompetition clauses, the oldest of which dated 1970. See generally Annotation, *Conflict of Laws as to Validity, Enforceability, and Effect of Ancillary Restrictive Covenant Not to Compete, in Contract of Employment or for Sale of Business*, 70 A.L.R. 2d 1292 (1960).

126. See, e.g., *Northern Petrochemical Co. v. Tomlinson*, 484 F.2d 1057 (7th Cir. 1973); *Franke v. Wiltschek*, 209 F.2d 493 (2d Cir. 1953); *Sarkes Tarzian, Inc. v. Audio Devices, Inc.*, 166 F. Supp. 250, 260 (S.D. Cal. 1958), *aff'd mem.*, 283 F.2d 695 (9th Cir. 1960); see also *Durham v. Stand-By Labor, Inc.*, 230 Ga. 558, 563, 198 S.E.2d 145, 149 (1973) ("general confidential business and customer information . . . is fully protectable in the absence of contract if procured by improper means or otherwise disclosed without privilege, as in violation of relationships of confidence").

127. *Bull v. Logetronics, Inc.*, 323 F. Supp. 115, 132 (E.D. Va. 1971) (employee is fiduciary with respect to information obtained during employment); *By-Buk Co. v. Printed Cellophane Tape Co.*, 163 Cal. App. 2d 157, 164 (1958) (employee holds confidential information in trust for the employer and cannot use it in violation of his trust); *Allen Mfg. Co. v. Loika*, 145 Conn. 509, 515, 144 A.2d 306, 309 (1958) (employee's receipt of information by employer's confidence requires employee not to "fraudulently abuse the trust reposed in him"); *Lincoln Towers Ins. Agency v. Farrell*, 99 Ill. App. 3d 353, 358-59, 425 N.E.2d 1034, 1038 (1981) (employee breaches confidential relationship with employer when he "surreptitiously copies or memorizes" trade secrets with the intent to harm the employer); *Koch Eng'g Co., Inc. v. Faulconer*, 227 Kan. 813, 826, 610 P.2d 1094, 1105 (1980) (confidential relationship exists when employer entrusts trade secrets information to employee); *David Fox & Sons, Inc. v. King Poultry Co.*, 262 N.Y.S.2d 983, 987-88 (1964) (when employer entrusts confidential information to "trusted employee," employee cannot use that information to his own ends).

128. "[M]odern economic growth has pushed the business venture beyond the size of the [small] firm, forcing the [employer] to a much greater degree to entrust confidential business

forced disclosure creates risks for the employer, increasing the relative "strength," or bargaining position, of the employee.<sup>129</sup>

Although many trade secret cases focus on the employer's threshold burden of proving that the information in question is a trade secret,<sup>130</sup> the cases occasionally intermingle concepts of trade secret with concepts of the duty of utmost good faith and loyalty.<sup>131</sup> Duties of trade secret and loyalty are infused with the same "special relationship" factors of longevity of service, trust, and confidentiality<sup>132</sup> that underlie the implied covenant of good faith and fair dealing.

The "loyalty" and "trade secrets" cases strongly suggest that extension of the covenant of good faith and fair dealing duties, at least to employees occupying positions of special trust and confidence, would be consistent with both precedent and current case law. Both tort actions are concerned with employee conduct in abuse of a "special relationship"

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information . . . to appropriate employees." Gilburne & Johnson, *Computer Software Protection Available in Trade Secrets Law*, Legal Times, Nov. 22, 1982, at 20, col. 4.

129. Note, *Balancing Employers' Trade Secret Interests in High-Technology Products Against Employees' Rights and Public Interests in Minnesota*, 69 MINN. L. REV. 984, 991 (1985).

The necessary disclosure of confidential information prompted creation of the Uniform Trade Secrets Act. UNIF. TRADE SECRETS ACT, 14 U.L.A. 541-51 (1980). Nine states have adopted the model act. See ARK. STAT. ANN. §§ 70-1001 to -1007 (Supp. 1983) (effective Mar. 12, 1981); 1983 Conn. Reg. Acts 344 (effective June 23, 1983); DEL. CODE ANN. tit. 6, §§ 2001-2009 (Supp. 1982) (effective Apr. 15, 1982); IDAHO CODE §§ 48-801 to -807 (Supp. 1984) (adopted 1981); IND. CODE ANN. §§ 24-2-3-1 to 24-2-3-8 (Burns Supp. 1984) (effective Sept. 1 1982, except as provided in § 24-2-3-8); KAN. STAT. ANN. §§ 60-3320 to -3330 (Supp. 1982) (effective July 1, 1981); LA. REV. STAT. ANN. §§ 51:1431 to :1439 (West Supp. 1984) (adopted July 19, 1981); MINN. STAT. §§ 325 C.01-.08 (1984) (effective Jan. 1, 1981); WASH. REV. CODE ANN. §§ 19.108.010 to .940 (West Supp. 1984) (effective Jan. 1, 1982). In addition, North Carolina's Trade Secrets Protection Act borrows from both the model act and the common law. See N.C. GEN. STAT. §§ 66-152 to -157 (Supp. 1981) (effective Oct. 1, 1981).

The Trade Secrets Act is an effort to strike a balance between employers' rights to protect their property and employees' rights to advance their careers. Note, *supra*, at 985. Modeled along the lines of the Restatement test for misappropriation, RESTATEMENT OF TORTS § 757 (1934), disclosure of trade secrets without privilege to do so imposes liability on the disclosing party if the secret was discovered by improper means (e.g., industrial espionage) or if disclosure breached a confidential relationship, such as that between principal and agent.

Liability for disclosure under the Act results only from "bad faith conduct, such as . . . abuse of confidence. . . ." Note, *supra*, at 988 n.18

130. E.g., AMP, Inc. v. Fleischhacker, 823 F.2d 1199, 1206 (7th Cir. 1987) (former employer's failure to establish trade secret); Cudahy Co. v. American Labs., Inc., 313 F. Supp. 1339, 1344 (D. Neb. 1970) (failure to prove trade secret).

131. United Bd. & Carton Corp. v. Britting, 63 N.J. Super. 517, 532-33, 164 A.2d 824, 828 (1959) (employee disloyalty found actionable where employee used employer's customer list to compete with employer while still employed), *cert. denied*, 33 N.J. 326, 164 A.2d 379 (1960).

132. One commentator recommended that the threshold criteria to establish constructive knowledge of trade secret include length of service or position that requires familiarity with an employer's "policies, goals, products, and marketing strategies." Note, *supra* note 129, at 1003-04.

in which the employer is prevented from realizing its reasonable expectation of benefits from the employment contract.<sup>133</sup> Moreover, the trust or confidentiality inherent in the relationship makes it "special."<sup>134</sup> The degree of trust determines what duties will be implied in law<sup>135</sup> and the corresponding standard of conduct with which the employee must perform those duties.<sup>136</sup>

The common law currently imposes the good faith duties of loyalty and trade secret<sup>137</sup> on employees in much the same way that courts impose the duty of good faith and fair dealing on the employer. The duty of utmost good faith and loyalty is described in language similar to that defining the implied covenant of good faith and fair dealing.<sup>138</sup> Under both theories, duties are imposed on the respective parties,<sup>139</sup> and similar "special relationship" considerations limit the tort actions available for breach of these duties.<sup>140</sup>

In addition, it is also apparent that courts use similar rationales to justify the common-law employee duties and the employer's duty of good faith and fair dealing. When the employer's interests are threatened to a greater degree than the employee's interests, the common law generally provides equitable relief,<sup>141</sup> and occasionally punitive damages,<sup>142</sup> to prevent the employee from abusing his position of trust.<sup>143</sup> Conversely, when the employee's interests are paramount, and the employer is in a significantly greater bargaining position, as in the employment termination context,<sup>144</sup> the employer is held to a higher standard of conduct<sup>145</sup> by application of the implied covenant of good faith and fair dealing.<sup>146</sup>

Extension of the implied duties of good faith and fair dealing to em-

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133. *Id.* at 988 n.18 (requirement of good faith is central to all subparts of RESTATEMENT OF TORTS § 757 (1934)); *see supra* note 129; Robison, *supra* note 92, at 374-76 (reasonable for employer to expect that its trade secrets will be respected beyond the tenure of the employment relationship; reasonable for employee to expect that he will be able to pursue his employment as he chooses, as long as the trade secrets are not compromised); *see also AMP, Inc.*, 823 F.2d at 1206 (absent restrictive covenant, court will protect "protectible business interest" on showing of irreparable harm absent injunctive relief).

134. *See supra* notes 123-29 and accompanying text.

135. *See supra* note 94.

136. An employee is imputed the duty of loyalty; an agent is imputed the duty of utmost good faith and loyalty. The employee's duty extends during the tenure of his employment relationship; the agent's duties can extend beyond the term of employment. *Id.*

137. *See supra* notes 107-31 and accompanying text.

138. *See supra* note 118 and accompanying text.

139. *See supra* notes 119-31 and accompanying text.

140. *See supra* note 120 and accompanying text.

141. *See supra* note 116 and accompanying text.

142. *See supra* note 113 and accompanying text.

143. *See supra* note 113.

144. *See supra* note 84.

145. *See supra* note 83 and accompanying text.

146. *See supra* notes 84, 85 and accompanying text.



ployees occupying special positions of trust and confidence thus would provide a coherent theoretical structure for tortious breach of the implied covenant consistent with existing case law.

### III. Constructing a Theory of Employees' Implied Duty of Good Faith and Fair Dealing

#### A. The Insurance Model

In the context of insurance bad faith actions, the law seems to recognize the *insured's* good faith duties. In *California Casualty General Insurance v. Superior Court* (Gorgei),<sup>147</sup> an insured sued her insurer for breach of the duty of good faith and fair dealing.<sup>148</sup> The appellate court allowed the insurer to allege an affirmative defense of "comparative bad faith."<sup>149</sup> The court reasoned that when contracting to provide insurance, an insurer's reasonable expectations are that its insured will "promptly and accurately furnish it with all the information and evidence pertinent to the claim that is known to the insured."<sup>150</sup> Basing its holding on comparative fault principles,<sup>151</sup> the court determined that an insured's breach of the implied covenant that contributes to her insurer's failure to perform or delay in performing contract duties may constitute a partial defense to the insured's damage action for the insurer's breach of its duty of good faith and fair dealing.<sup>152</sup>

By making the plaintiff comparatively liable for its bad faith actions, the court gave meaning to the traditional "two-way street" description of

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147. 173 Cal. App. 3d 274, 218 Cal. Rptr. 817 (1985).

148. Plaintiff also alleged breach of insurer's statutory duties under the unfair practices act, California Insurance Code § 790.03, fraud, and intentional infliction of emotional distress. *California Casualty Gen. Ins.*, 173 Cal. App. 3d at 276-77, 218 Cal. Rptr. at 818.

149. *Id.* at 284, 218 Cal. Rptr. at 823. Insured alleged defendants failed to investigate and process his claim in a reasonable and timely manner, failed to effectuate a fair settlement of the claim, and failed to pay under an uninsured motorist provision of the policy. The insurer asserted comparative bad faith, claiming that

plaintiff . . . [is] guilty of bad faith conduct in the prosecuting, handling and management of the uninsured motorist claim . . . and as a proximate cause of [her] bad faith acts, omissions and failure to provide full and complete information to the defendants . . . defendants request that any damages awarded against them for bad faith be reduced by the amount of the bad faith conduct of plaintiff.

*Id.* at 277-78, 218 Cal. Rptr. at 818-19

150. *Id.* at 282, 218 Cal. Rptr. at 822.

151. See *Li v. Yellow Cab Co.*, 13 Cal. 3d 804, 532 P.2d 1226, 119 Cal. Rptr. 858 (1975) (comparative fault applied to negligent conduct); *Safeway Stores, Inc. v. Nest-Kart*, 21 Cal. 3d 322, 579 P.2d 441, 146 Cal. Rptr. 550 (1978) (comparative fault between two tortfeasors one of whose liability was based on strict products liability and the other on negligence); *Daly v. Gen. Motors Corp.*, 20 Cal. 3d 725, 575 P.2d 1162, 144 Cal. Rptr. 380 (1978) (comparative fault applied between strictly liable defendant and a negligent plaintiff).

152. *California Casualty Gen. Ins.*, 173 Cal. App. 3d at 283, 218 Cal. Rptr. at 822 (1985).

the duty of good faith and fair dealing in an insurance policy.<sup>153</sup> The reciprocal nature of the good faith duties implied in law has been the subject of several recent insurance cases,<sup>154</sup> all holding that the obligations inherent in the implied covenant rest "as much on the insured as on the insurer."<sup>155</sup>

Further, several insurance cases suggest that an insured's breach of the implied covenant will justify tort liability to the insurer. In *Liberty Mutual Insurance Co. v. Altfillisch Construction Co.*,<sup>156</sup> the court held that the insured had breached its implied covenant of good faith and fair dealing by attempting to contract away the insurer's subrogation rights before any policy losses had occurred.<sup>157</sup> Although *Altfillisch* resulted in an equitable award,<sup>158</sup> the court recognized that tort liability for breach of the implied covenant "devolve[s] alike upon the insured as well as the insurer."<sup>159</sup> The *Altfillisch* court might be criticized, however, for its failure to discuss the difference, if any, between the good faith duties imputed to an insured and those duties imputed to a subrogor.

Consistent with *Altfillisch*, a recent California case suggested that an insurer's failure to prove fraud<sup>160</sup> did not preclude other remedies, including an "independent 'reverse bad faith' action by the insurer against

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153. *Id.* (citing *Commercial Union Assurance Co. v. Safeway Stores, Inc.*, 26 Cal. 3d 912, 918, 610 P.2d 1038, 1041, 164 Cal. Rptr. 709, 712 (1980)).

154. *Insurance Co. of North Am. v. Moore*, 783 F.2d 1326, 1327 (9th Cir. 1986) (in dicta, acknowledging that "the implied covenant of good faith and fair dealing places a corresponding duty on the insured"); *Johnson v. Southern State Ins. Co.*, 286 S.C. 235, 236, 332 S.E.2d 778, 779 (S.C. Ct. App. 1985) (duty of good faith rests as much on the insured as the insured), *rev'd on other grounds*, 288 S.C. 239, 341 S.E.2d 793 (1986).

155. *Id.*; see also *Commercial Union Assurance Co. v. Safeway Stores, Inc.*, 26 Cal. 3d 912, 919, 610 P.2d 1038, 1041, 164 Cal. Rptr. 709, 712 (1980) (citing *Liberty Mut. Ins. Co. v. Altfillisch Constr. Co.*, 70 Cal. App. 3d 789, 797, 139 Cal. Rptr. 91, 95 (1977); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 429, 426 P.2d 173, 176, 58 Cal. Rptr. 13, 16 (1967)).

156. 70 Cal. App. 3d 789, 797, 139 Cal. Rptr. 91, 95 (1977).

157. *Id.* at 797, 139 Cal. Rptr. at 95. The insurer had underwritten an insurance policy on construction equipment owned and leased by Conexco. Conexco had leased the equipment to Altfillisch and for consideration agreed to act as Altfillisch's surety in the case of damage to the equipment. When Altfillisch's employees negligently damaged the equipment, Liberty Mutual paid Conexco for the loss, then pursuant to its policy, proceeded to assert its subrogation rights against Altfillisch. *Id.* at 792-94, 139 Cal. Rptr. at 92-93. It was then that Liberty Mutual learned of Conexco's surety agreement with Altfillisch, which precluded an action on behalf of Conexco against Altfillisch. *Id.*

158. The *Altfillisch* court affirmed the judgment voiding the insurance policy between Conexco and Liberty and required Conexco to reimburse the funds Liberty had previously paid under the policy for the loss. *Id.* at 796, 139 Cal. Rptr. at 94.

159. *Id.* at 797, 139 Cal. Rptr. at 95.

160. *Orient Handel v. United States Fidelity & Guar.*, 192 Cal. App. 3d 684, 695, 237 Cal. Rptr. 667, 673 (1987) (dictum) (seeking to recover its attorney's fees and costs of investigation, insurer failed to prove that it had actually relied on its insured's misrepresentations when initiating its investigation).

its insured"<sup>161</sup> to recover damages. In *Orient Handel v. United States Fidelity and Guaranty*,<sup>162</sup> the insureds had allegedly committed a burglary against their own store in order to recover the loss against its insurance policy.<sup>163</sup> Although the court expressly refused to consider a "reverse bad faith" action because the insurer had not advanced the theory, it implied that the circumstances might support such a claim.<sup>164</sup>

The insurance cases clearly support assertion of the implied covenant against an insured as an affirmative defense<sup>165</sup> and arguably support an independent action grounded in an implied covenant theory.<sup>166</sup> Since the courts have extended the insurance bad faith model to the employment context in suits by employees against their employers,<sup>167</sup> it is possible that the courts would support such an extension in a "reverse bad faith" action.

To reach this result, one must conclude that under certain circumstances<sup>168</sup> the law can theoretically impute duties to the employee under the covenant of good faith and fair dealing. The legal propriety of such an extension, however, still remains in question. The only decision to address this issue squarely, *Hudson v. Moore Business Machines*,<sup>169</sup> has suggested that liability for tortious breach of the implied covenant may run only against the employer, as the "stronger" party to the contract. A closer examination of *Hudson*, however, reveals that such a conclusion is subject to serious question in light of the narrow facts of that case and the subsequent case law undercutting *Hudson's* broad rationale.

## B. The *Hudson* Case

As the only case on record discussing employee's breach of the implied covenant of good faith and fair dealing, *Hudson v. Moore Business Forms*<sup>170</sup> raises a number of interesting questions.

In *Hudson*, a former employee sued her former employer alleging alleging several theories, including breach of the implied covenant of good faith and fair dealing.<sup>171</sup> The defendant counterclaimed, alleging

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161. *Id.* at 696-97, 237 Cal. Rptr. at 674.

162. 192 Cal. App. 3d 684, 237 Cal. Rptr. 667 (1987).

163. *Id.* at 692-93, 237 Cal. Rptr. at 671.

164. *Id.* at 697, 237 Cal. Rptr. at 674.

165. *See supra* notes 147-55 and accompanying text.

166. *See supra* notes 156-64 and accompanying text.

167. *See supra* notes 63-66 and accompanying text.

168. These circumstances are described as "special" or fiduciary relationships. *See supra* note 102.

169. 609 F. Supp. 467 (N.D. Cal. 1985), *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987).

170. *Id.*

171. *Id.* at 470.

violations of various sections of the California Labor Code<sup>172</sup> and the employee's breach of the duty of good faith and fair dealing.<sup>173</sup> The essence of the defendant's counterclaim regarding the good faith and loyalty allegations were charges that the former employee had breached certain "duties imposed by her 'employment relationship' by denying the existence of a contract in which she allegedly agreed to be terminated in return for the receipt of severance benefits."<sup>174</sup>

Since the employment relationship is "special,"<sup>175</sup> the court required the party asserting the implied covenant claim to demonstrate the *Wallis* elements<sup>176</sup> to justify the extension of tort liability to what was essentially a breach of contract.<sup>177</sup> The court noted that in *Wallis* the superior party (employer) was the breaching party; in *Hudson*, the clearly inferior party (employee)<sup>178</sup> allegedly breached the agreement. The court reasoned that current law allowed only the weaker party to recover in tort for breach of the implied covenant, and consequently denied the employer any right to tort damages against its former employee.<sup>179</sup>

If, as repeatedly stated by the courts, the implied covenant of good

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172. *Id.* (defendants alleged violation of CAL. LAB. CODE §§ 2854, 2856-59, and 2865 (1937)).

173. *Hudson*, 609 F. Supp. at 470.

174. *Id.* at 477 (Defendants contended that employee's bad faith denial of the termination agreement fit squarely within the arena created by *Seaman's*, and quoted the language in *Seaman's* justifying tort relief when the breaching party denies, "in bad faith and without probable cause, that the contract exists." (citing *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 762, 769, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 354 (1984)).

The court noted that *Seaman's* bad faith denial tort action is limited to "ordinary commercial contract[s], where the parties are of 'roughly equal bargaining power . . .'" The Court also observed that earlier it had recognized the availability of tort damages for breach of the implied covenant in agreements, including employment contracts, characterized by elements of "public interest, adhesion, and fiduciary responsibility." *Hudson*, 609 F. Supp. at 478 (quoting *Seaman's*, 36 Cal. 3d at 768-69 & n.6, 686 P.2d at 1166 & n.6, 206 Cal. Rptr. at 362 & n.6).

175. *Hudson*, 609 F. Supp. at 475 n.2.

176. *See supra* note 81 and accompanying text.

177. *Hudson*, 609 F. Supp. at 475 n.2 (plaintiff must satisfy *Wallis* test as condition precedent to stating a claim for tortious breach of the implied covenant); *id.* at 478 (defendant must satisfy *Wallis* test to state a valid counterclaim for tortious breach of the implied covenant).

178. The court made much of the disparity between defendant, a national corporate concern, and plaintiff, a middle-aged woman whose husband was retired. *Hudson*, 609 F. Supp. at 479.

179. *Id. Contra Note, Patent Ownership: An Employer's Rights to His Employee's Invention*, 58 NOTRE DAME L. REV. 863, 876 (1983) (in the context of express agreements for assignment of future invention rights to the employer contained in employment contracts, "[t]he courts seem to ignore the employer's inherently stronger bargaining position and superior legal knowledge." (citing *Fish v. Air-O-Fan Prod. Co.*, 285 F.2d 208 (9th Cir. 1960)); *Conway v. White*, 9 F.2d 863, 866 (2d Cir. 1925); *Hewett v. Samsonite Corp.*, 32 Colo. App. 150, 155, 507 P.2d 1119, 1122 (1973)).

faith and fair dealing inheres to both parties to a contract,<sup>180</sup> then the court's statement that only "the employer . . . can be held liable in tort for breach of the covenant of good faith and fair dealing implied in an employment contract"<sup>181</sup> is open to question.<sup>182</sup> Insurance bad faith litigation<sup>183</sup> casts doubt on *Hudson's* emphasis on the relative financial strength of the parties and its conclusion that the party with greater financial strength lacks standing to sue for breach of the implied covenant.

These cases suggest that *Hudson* was clearly wrong to the extent that it intended a blanket rule against allowing implied covenant of good faith and fair dealing claims against employees. While the *Hudson* court was probably correct in the result of its decision,<sup>184</sup> it interpreted the *Wallis* test too narrowly when it concluded that "only . . . the employer . . . can be held liable in tort for breach of the covenant of good faith and fair dealing implied in an employment contract."<sup>185</sup>

### C. The Fiduciary Model

Even if one were to accept *Hudson's* rationale that only the "stronger" party may be held liable for breach of the covenant, it may still be asserted that an employee occupying special positions of trust and confidence is the "stronger" party. Because of their positions, such employees possess a peculiar ability to damage the interests of their employer. A common characteristic of the relationships that give rise to tort damages for breach of the implied covenant of good faith and fair dealing is the "fiduciary" nature of the relationship.<sup>186</sup> A fiduciary relationship has been described as a relationship in which one party, the "en-

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180. The articulation of the implied covenant of good faith and fair dealing, "that neither party will do anything" to deprive the other party of the benefits of the contract impliedly includes both parties to a contract. For definite statements of the reciprocal nature of the implied covenant, see *Los Angeles Memorial Coliseum Comm'n v. National Football League*, 791 F.2d 1356, 1361 (9th Cir. 1986); *California Casualty Gen. Ins. v. Superior Ct.*, 173 Cal. App. 3d 274, 283, 218 Cal. Rptr. 817, 822 (1985); *Commercial Union Assurance Co. v. Safeway Stores*, 26 Cal. 3d 912, 918, 610 P.2d 1038, 1041, 164 Cal. Rptr. 709, 712 (1980); *Johnson v. Southern State Ins. Co.*, 286 S.C. 235, 236, 332 S.E.2d 778, 779 (S.C. Ct. App. 1985), *rev'd*, 288 S.C. 239, 341 S.E.2d 793 (1986).

181. *Hudson*, 609 F. Supp. at 479.

182. Applying the concept of "comparative bad faith" to the case of an employer suing its former employee for breach of the implied duty of good faith and fair dealing supports the assertion that, under some circumstances, such an action is possible. See *supra* notes 147-54 and accompanying text (insurance context).

183. *Id.*

184. Defendant made an "unconscionable claim for \$4 million dollars" in punitive damages. The court described this as an "overzealous attempt on the part of defendants' counsel to intimidate this and other plaintiffs from pursuing wrongful discharge litigation." *Hudson*, 609 F. Supp. at 480.

185. *Id.*

186. See *supra* note 102 and accompanying text.

trustor," is dependent on the other party, the fiduciary.<sup>187</sup> The common purpose of these tortious bad faith actions is to prevent the "entrustor" from abusing the power with which it has been entrusted.<sup>188</sup> The "entrustor" is the insured in the context of insurance contracts, as is the employee in the context of employment contract termination. In the context of trade secrets, however, the entrustor is the employer.

It is possible then, for the balance of strength to shift in the employee's favor in certain circumstances. A party that is dependent (*i.e.*, the entrustor) in some circumstances can be the stronger party (*i.e.*, the fiduciary) in others.<sup>189</sup>

For example, when employees work with trade secrets, their "importance in a special sense increases . . . . The firm [has] to repose 'confidence' in the employee, to 'trust' him not to spread the information outside the firm during and after the relationship."<sup>190</sup> The employer can be described as the "entrustor" when it comes to trade secrets,<sup>191</sup> and the "fiduciary" when it comes to administering company termination policy.<sup>192</sup> In short, when an employee occupies some position of special trust and confidence with regard to matters essential to his employer's business, that employee should appropriately be subject to a "heightened duty" of conduct in which he must consider the employer's interests "as tantamount to his own."<sup>193</sup>

This "heightened duty" concept is fully consistent with the policy objectives underlying existing implied covenant cases. The general policy objectives that are served by extending tort damages to breach of the implied covenant are two-fold. On the one hand, the courts are concerned with protecting the heightened expectations that the entrustor brings to a special relationship.<sup>194</sup> On the other hand, the courts attempt to prevent the fiduciary from abusing his position of trust.<sup>195</sup> By extending the implied covenant cause of action to those employers that must repose trust and confidence in their employees,<sup>196</sup> the law can provide a remedy that deters abuse of the "special relationship" and compensates the employer when existing contract or tort law now fails to do

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187. Frankel, *supra* note 104, at 800 n.17.

188. *Id.* at 809-10; Note, *supra* note 116, at 865.

189. Frankel, *supra* note 104, at 800.

190. Robison, *supra* note 92, at 376.

191. *See supra* notes 122, 127 and accompanying text.

192. *Cf. Rulon-Miller v. IBM*, 162 Cal. App. 3d 241, 247-48, 208 Cal. Rptr. 524, 529 (1984) (employee has right to the benefit of rules and regulations adopted for his benefit; employer has duty to apply those rules to insure that like cases are treated alike).

193. *Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1119, 207 Cal. Rptr. 123, 129 (1984).

194. *See supra* notes 79-80 and accompanying text.

195. Frankel, *supra* note 104, at 816.

196. *See supra* note 129 and accompanying text.

so.<sup>197</sup> This is especially true when the employer is particularly vulnerable to the loss of "key" personnel.<sup>198</sup>

#### IV. Employees' Tortious Breach of the Implied Covenant: A Viable Cause of Action?

As discussed above, since the law already provides tort relief for breaches of certain common-law employee duties, the viability of extending tort liability to employees for breach of the implied covenant of good faith and fair dealing remains in question.

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197. The *Wallis* test, if rigorously required, will likely prevent an employer from asserting an action based in the implied covenant because, the *Hudson* court reasoned, the employer is almost never the "weaker" party economically. *Hudson v. Moore Business Forms*, 609 F. Supp. 467, 479 (N.D. Cal. 1985), *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987).

By de-emphasizing economic strength, it is possible to imagine an instance, such as a trade secrets dispute, in which the *Wallis* test might allow an employer to sue for employee's breach of the implied covenant: (1) the employee entrusted with the use or creation of confidential information can arguably assume an equal or superior bargaining position, depending upon the relevant value of that information to the employer. In the context of salary negotiations, for instance, the employee could "hold up" the employer for significant salary and fringe benefit advantages against the unstated threat to divulge the information, or leave the company prior to completion of the development work in process; (2) the employer might enter into such an agreement with an employee to provide security of future operations; (3) if the employee left prematurely, or divulged the confidential information, the employer could possibly suffer damages *vis-a-vis* lost opportunities and loss of competitive position far in excess of normal contract damages (*i.e.*, employee's salary); (4) the employer could be especially vulnerable to loss of "key" personnel and the attendant competitive advantage they represent; and (5) the employee would likely be aware of the type and extent of the employer's vulnerability.

The *Wallis* test addresses many of the concerns that arise during the contract formation stage, when "bargaining power" is most significant. *Wallis* arguably is not, however, flexible enough to account for the results reached by the courts deciding the "comparative bad faith" cases.

Perhaps a better way to describe the imbalance of power that the courts seek to equalize by applying tort damages to breach of the implied covenant is to talk of the relative position of trust that the party occupies, as either the "entrusted" or the "trusting." Frankel, *supra* note 104, at 800 n.17. This Note suggests that when the party is in the position of fiduciary (entrusted), then he should be liable in tort for breach of the implied covenant.

198. *Commonwealth v. Levin*, 11 Mass. App. Ct. 482, 484, 417 N.E.2d 440, 442 (1981) ("[K]ey man insurance . . . enables a company to insure the life of a person whose continued services are critical to the financial success of the company's business."). "Key man" insurance is a relatively common condition precedent for receipt of loan approval or financing agreement perfection in start-up ventures. In this manner, new research and development concerns can recover damages sustained by the loss of critical creative personnel. The "key man" need not be a corporate officer, director, manager, or other typically corporate "fiduciary." See, e.g., *Curtis v. Mendenhall*, 208 Cal. App. 2d 834, 25 Cal. Rptr. 627 (1962) (entrepreneur with 20 years experience in venture was the "key man, his life [was] insured."); *Gates v. American Nat'l Bank*, 173 Colo. 371, 479 P.2d 285 (1971) (key-man life insurance for the company officers); *McMullen v. St. Lucie County Bank*, 128 Fla. 745, 175 S. 721 (1937) (bank secured key man insurance for heavily indebted borrowers).

### A. Arguments For Employee's Tortious Breach of the Implied Covenant Actions

First, tort actions for breach of the duty of loyalty and breach of the duty of secrecy are generally equitable actions. Damages are therefore limited to the amount that the employer was harmed. These remedies provide minimal deterrence against bad faith conduct.<sup>199</sup> The availability of punitive damages for breach of the implied covenant might deter employees in positions of trust from abusing their positions.<sup>200</sup>

Additionally, some plaintiffs may face difficulties trying to "pigeon-hole" their claims into a traditional tort. The availability of a general tort action for breach of the implied covenant of good faith and fair dealing would simplify pleading, and thus prove consistent with the goals of modern fact pleading.<sup>201</sup>

Finally, recognizing "comparative bad faith" as a "defense" or as an offset to liability,<sup>202</sup> would add to the employer's "arsenal" in the case of a "wrongful termination" case against him.<sup>203</sup>

More important, however, extension of tortious breach of the covenant of good faith and fair dealing liability to employees in special positions of trust and confidence would maintain a consistency between traditional common-law duties and the rapidly growing case law surrounding the implied covenant. The public interest in protecting the "entrustor" and deterring abuse by the "entrusted" is firmly established in the context of insurance contracts, and to a lesser degree employment contract terminations, loan agreements, and other contexts. Certain employee's duties have been implied in law, or required by statute,<sup>204</sup> with the purpose of balancing the rights of the employer against those of the employee.<sup>205</sup> In the context of trade secret and loyalty disputes, the employer's property interests are balanced against the employee's interest in advancing his career.<sup>206</sup> In the context of employment termination disputes, the court balances the employer's interest in maintaining manage-

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199. See Note, *supra* note 116, at 864-65.

200. *Id.* at 859-61; *Jones v. H.F. Ahmanson*, 1 Cal. 3d 93, 105, 460 P.2d 464, 470, 81 Cal. Rptr. 592, 597 (1969) (majority stockholders' manipulation of corporate stock, while clearly damaging to minority shareholders, was not subject to legal remedy as minority shareholders lacked standing to sue in diversity action); *Hicks v. Clayton*, 67 Cal. App. 3d 251, 264, 136 Cal. Rptr. 512, 520 (1977) (noting the inadequacy of equitable and compensatory damages to provide remedy for defendant's breach of fiduciary duty).

201. J. FRIEDENTHAL, M.K. KANE & A. MILLER, *CIVIL PROCEDURE* 238 (1985) ("A vital aspect of pleading reform was application of a uniform set of rules to all cases, regardless of the nature of the substantive cause.").

202. See *supra* notes 147-55 and accompanying text.

203. See *Hudson v. Moore Business Machines*, 609 F. Supp. 467, 480 (N.D. Cal. 1985), *aff'd in part and vacated in part*, No. 85-2176, slip op. (9th Cir. Sept. 2, 1987).

204. E.g., Uniform Trade Secrets Act, 14 U.L.A. 541-51 (1980).

205. Note, *supra* note 129, at 985-86.

206. *Id.*



ment control of its business against the employee's interests in job security and non-discriminatory application of company policy.<sup>207</sup> In all of these cases, the party entrusted with protecting the other party's interests (*i.e.*, "fiduciary") is subject to tort liability. Consequently, in certain situations, tort liability for employee breach of the covenant is both logical and appropriate.

#### B. Arguments Against Employee's Tortious Breach of the Implied Covenant Actions

In contrast to the foregoing, significant reasons argue against allowing employers to assert tortious breach of the implied covenant claims against former employees. First, employers already have available a significant body of statutory and common-law actions to pursue against employees who breach the duties required therein. Creation of a tort action based on the implied covenant might further tip the balance of power historically weighed in the employer's favor.<sup>208</sup>

Second, as the *Hudson* court recognized, providing employers with as flexible a cause of action as tortious breach of the implied covenant will allow them to "harass . . . plaintiff[s] and scare off other litigants."<sup>209</sup> Thus, when faced with the "full weight and resources of the employer"<sup>210</sup> behind a claim seeking compensatory and punitive damages, employees may be deterred from asserting their rights in meritorious cases. This has not been the case with employers' common-law and statutory actions against former employees, perhaps due to the limited equitable remedies generally available under such actions.<sup>211</sup> Given that most employees are relatively "judgment proof" against large claims against them, it is unlikely that employers' claims for large damages would be asserted offensively for other than harassment purposes.

Third, as recognized by Justice Kaus in *White v. Western Title Insurance Company*,<sup>212</sup> while "there is tremendous pressure . . . to extend bad faith liability to other [than insurance] relationships . . . it would be disastrous if every contract were to be subjected to the same set of rules which we have applied in the context of the insurer-insured relationship."<sup>213</sup> Although primarily concerned with subjecting ordinary contractors to "almost unlimited liability for punitive damages,"<sup>214</sup> Justice Kaus suggested that the rules to which the insurer-insured relationship

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207. *Rulon-Miller v. IBM*, 162 Cal. App. 3d 241, 247-48, 208 Cal. Rptr. 524, 529 (1984).

208. *See supra* note 117.

209. *Hudson*, 609 F. Supp. at 480.

210. *Id.*

211. *See supra* notes 113-16 and accompanying text.

212. 40 Cal. 3d 870, 900, 710 P.2d 309, 327, 221 Cal. Rptr. 509, 527 (1985) (Kaus, J., concurring in part and dissenting in part).

213. *Id.* at 900, 710 P.2d at 327-28, 221 Cal. Rptr. at 527-28.

214. *Id.* at 900-02, 710 P.2d at 327-29, 221 Cal. Rptr. at 527-28.

are subject may not be appropriate to other contractual relationships. While an insurer's good faith duties may be readily definable,<sup>215</sup> this has apparently not been the case for employers.<sup>216</sup> Other than the specific duties to which the employee is already subject,<sup>217</sup> liability for amorphous good faith duties may only serve as a redundant, although powerful, tool for employers' abuse.

## V. Conclusion

The implied covenant of good faith and fair dealing, originally a contract interpretation device whose breach resulted in contract damages, is currently used by many jurisdictions to impose tort liability for its breach in the context of "special" contracts. While courts offer various rationales to justify their use of the implied covenant in this fashion, all agree that some contracts have significant policy implications. The courts therefore embrace tort remedies to compensate plaintiffs more adequately and to deter wrongful conduct more effectively.

Early cases used the implied covenant to provide tort remedies to insureds suing their carriers. Subsequent cases have extended these tortious breach actions to other contractual relationships displaying quasi-fiduciary characteristics. The courts have found this quasi-fiduciary relationship to exist in the context of surety contracts, loan agreements, commercial leases, and franchise agreements.

More recently, the courts have extended the "special relationship" rationale into the employment context, allowing employees to state a cause of action for tortious breach of the covenant of good faith and fair dealing in certain wrongful discharge situations. The courts have yet to hold an employee explicitly liable for tortious breach of the covenant. Yet both law and logic suggest that such a cause of action might be appropriate when an employee abuses a special position of trust and confidence in relation to his employer.

The common law traditionally imputes heightened duties of loyalty and confidentiality to an employee entrusted with interests belonging to his employer. The cases and the statutes seek to balance the employer's property interests with the employee's freedom to pursue his livelihood. For example, when the employer entrusts its trade secrets or authority to an employee, the employee is considered a fiduciary with respect to the employer's interest, and is therefore required to consider the employer's interest as tantamount to his own. In these cases, as in the implied covenant cases, the courts seek to deter and compensate for breach of agreements that require one party to entrust its interests to the other.

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215. See *supra* note 49 and accompanying text.

216. See *supra* notes 61-62 and accompanying text.

217. See *supra* notes 87-124 and accompanying text.

Common-law duties traditionally imputed to employees protect the same type of entrustment relationships protected by the implied covenant actions.

Consequently, it is theoretically sound for an employer to state a claim for employee's breach of the implied covenant of good faith and fair dealing. Notwithstanding the theoretical possibility of such an action, it may be desirable for the law to reject a tort cause of action in favor of employers because such an action may deter employees from bringing meritorious claims. The assertion of "comparative bad faith" as an affirmative defense, however, would not represent the evils of an independent claim, and thus may reduce the "[irksome] surge in wrongful discharge litigation"<sup>218</sup> without subjecting employees to harassment and intimidation.

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218. *Hudson*, 609 F. Supp. at 480.